



Investment in the People's Republic of China

Preface

This publication presents an overview of matters to be considered by those thinking of investing in the People's Republic of China (PRC). While the publication covers the relevant areas, it is not exhaustive and is not intended to provide the comprehensive information necessary to make investment decisions. Matters in the PRC are subject to frequent and rapid change in line with the country's economic development. Specific guidance should be obtained for each specific investment decision.

Please contact your local KPMG member firm if you require any other information or if you wish to discuss any matters specifically. Contact details are provided in Appendix II.

KPMG International is the coordinating entity for a global network of professional services firms, providing audit, tax, and advisory services, with an industry focus. The aim of KPMG member firms is to turn knowledge into value for the benefit of their clients, people, and the capital markets. With nearly 94,000 people worldwide, member firms provide audit, tax, and advisory services from 717 cities in 148 countries.

KPMG invests heavily to help ensure that partners and staff around the world are equipped with the latest information, technology, and training to provide the same high quality services to all member firm clients.

Further information about KPMG member firm's services in China is provided in Appendix I.

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While every effort has been made to ensure the accuracy of the information in this publication, member firm clients are reminded that the information is in summary form only, and we accept no responsibility for its authenticity or accuracy.

All sums are in US\$ unless otherwise stated. An average exchange rate of US\$1 = RMB8.3¹ has been used.

¹ 2003 and 2004 RMB Exchange Rates, State Administration of Foreign Exchange



1. Country outline

Geography and climate

The People's Republic of China (PRC), with a land mass of 9.6 million square kilometers, is the largest country in Asia and the third largest country in the world. It borders the Mongolian People's Republic in the North; the Commonwealth of Independent States and North Korea in the North-East; the Yellow Sea and the East China Sea in the East; the South China Sea, Vietnam, Laos, Burma, India, Bhutan, Sikkim, Nepal and Pakistan in the South; and the Commonwealth of Independent States and Afghanistan in the West.

Because of the PRC's size, the climate varies considerably. The North experiences seasonal conditions similar to those in Europe and North America, including severe winters, while the South is sub-tropical. Average rainfall ranges from 500 millimeters per year in the North to 2,000 millimeters per year in the South. The South China coast may also be affected by typhoons in summer and autumn.

History

The PRC's origins reach back to ancient times; the oldest discovered artifacts are over half a million years old. The country was feudal until a single empire, under the Qin dynasty, was created in 221 BC. Dynastic rule continued until 1911 when the Chinese Republic was founded. The period from 1911 to 1949 featured perpetual conflict leading to civil war between

the Chinese Communist Party and the right wing Kuomintang Party.

Following victory by the Chinese Communist Party in 1949, the present People's Republic of China was established.

The period from 1949 to the early 1970s was characterised by internal restructuring of the economy and reinforcement of ideologies. There was little contact with other countries. However, since the mid-1970s, the PRC has systematically established diplomatic and trade relations with most of the world's leading nations, and is now emerging as a major industrial nation. Foreign investment has been actively encouraged since the early 1980s. In particular, Special Economic Zones with considerable autonomy have been established to facilitate economic development.

Government

The National People's Congress (NPC) is the highest organ of state power. About 3,000 delegates are elected through a process of democratic consultation within the country's twenty three provinces, five autonomous regions, four municipalities, the Hong Kong Special Administrative Region, Macau Special Administrative Region and the People's Liberation Army. The NPC is elected for five years and meets once a year. When not in session, its powers are exercised by a Standing Committee assisted by a number of special

committees which work under its direction.

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

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

The Communist Party of China, a parallel authority, is run by a Central Committee. The politburo of this Central Committee is the most powerful political body in the country. One of its functions is to give advice to the NPC and its Standing Committee concerning the appointment and removal of the Premier and Vice-Premiers.

The country has a President who is appointed by the above bodies and is concerned with matters of state.

Hong Kong reverted to the PRC as a Special Administrative Region on 1 July 1997 and Macau followed on 20 December 1999.

In dealing with the PRC, it is important to realise that the central, provincial, regional and municipal governments may each have an interest in an issue and may each have the power to make regulations and take decisions concerning the issue. KPMG member firm partners responsible for the PRC are able to advise overseas investors concerning these inter-relationships.

Population and language

The PRC is the most populated country in the world. At the end of 2003, the PRC's population was more than 1.29 billion.²

Due to complex geographical factors, the population is unevenly distributed. The West is very sparsely populated. The main population concentrations are on the central plains, in Southern China and on the Eastern seaboard.

Written Chinese consists of ideographic characters and it is necessary to know thousands to be able to communicate effectively. While written Chinese is the same throughout the country, spoken Chinese varies from district to district. The most widely used dialect is Putonghua, commonly known as Mandarin. Other major dialects are Cantonese (commonly used in Hong Kong and parts of Southern China), Shanghainese, Fukienese and Hakka.

It is advisable for overseas visitors to arrange for translation and interpretation services when visiting

the PRC since knowledge of overseas languages within the country is very limited and most documentation and signs are in Chinese.

Currency

The official currency of the PRC is the Renminbi (RMB). The PRC government supervises the foreign exchange market through the State Administration of Foreign Exchange. Current-account foreign exchange receipts and disbursements are basically not subject to foreign exchange restrictions while capital-account foreign exchange receipts and payments are still subject to fairly strict control. Entities in the PRC (including domestic enterprises, institutions, government agencies and foreign investment enterprises) may buy and sell foreign currency in relation to trade and non-trade current-account receipts and payments through designated banks. RMB is not a freely convertible currency and there is a limit on the amount of currency which may be carried in and out of the PRC. The People's Bank of China announces daily exchange rates between the RMB and other major foreign currencies.

The foreign exchange reserves of the PRC were US\$403.3 billion³ by the end of 2003, the second largest in the world after Japan.

Foreign travellers may obtain RMB within the PRC at banks and authorised money changers and, if not used, a limited amount of that

originally purchased can be converted back to foreign currency when leaving the PRC.

Major credit cards are accepted at an increasing number of hotels, restaurants and shops in major cities and cash advances against credit cards are also possible in some cases. However, overseas visitors should note that credit cards are not as widely used or accepted in the PRC as in other countries and suitable alternatives, such as travellers checks, should be considered.

² "Statistical Communiqué on the 2003 National Economic and Social Development", National Bureau of Statistics of China

³ 2003 Foreign Reserve statistics, State Administration of Foreign Exchange

2. Working conditions

The PRC's infrastructure has been significantly upgraded in recent years. Its major airports meet international standards. Many international airlines now fly directly to the PRC. Numerous world standard hotels have been constructed in major cities. Telecommunications have also been improved considerably.

Overseas visitors and those taking up employment in the PRC are unlikely to experience any difficulties in the PRC's major cities. However, in the less developed areas, conditions are different and this should be taken into account.

Visa Requirements

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

Visas can also be issued upon arrival in certain cities of China. Foreign visitors may travel freely within the PRC. However, for some of the more remote cities and special locations, supplementary authorisations are required from the Public Security Bureau.

Visas are normally for a single entry and for a period of one month. Multi-entry visas for six months can also be obtained in places like Hong Kong. Foreigners wishing to take up employment need to apply for

employment visas from the PRC embassies and consulates upon presentation of an employment approval document issued by the Organisations Bureau. They should also apply to the Public Security Bureau for residence permits and will need evidence of sponsorship from their employing organisations in the PRC.

Medical

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

Overseas visitors can usually obtain the help they need from the medical facilities available in their hotels, but will be admitted to hospitals if necessary.

Western medicine is available in the major cities but not as widely as in other countries. Visitors to the PRC with medical problems are advised to carry sufficient medication with them for the period of their stay.

Housing

Foreigners will be able to locate suitable residential property, for rent or sale, in the major cities. The domestic property market in the PRC has

experienced rapid growth in recent years.

Leading hotels in all the major PRC cities offer long-stay accommodation arrangements for overseas visitors. In addition, many of these hotels are located in complexes which provide serviced apartments, and shopping and entertainment facilities. Many foreigners who take up work in the PRC find that this is the most suitable arrangement.

In the case of major projects, it may be necessary for the PRC employer to make its own arrangements, for example, by constructing accommodation for overseas staff.

Domestic accommodation suitable for foreigners is expensive and is broadly equivalent to making long-stay arrangements with three - to five-star hotels in other countries. At the end of 2003, the average monthly rental for an apartment in Beijing catering for foreigners is US\$20 per square meter.⁴

Education

The PRC provides a full range of primary, secondary and tertiary education for its people and some of its universities are internationally recognised. All teaching is in Chinese.

Education facilities for the children of overseas personnel are not well developed in the PRC. The major cities have international schools that cater especially for the foreign community.

⁴ Article on apartmental rental in Beijing, *Beijing Business Today*, 18 August 2004

Business hours and public holidays

Most PRC organisations work a five-day week from 8:00am until noon and then from 2:00pm to 5:30pm. Public organisations are generally closed on Saturdays and Sundays.

Official public holidays in the PRC are 1, 2 and 3 January and 1, 2 May and 3 October and the three-day Spring Festival, often referred to as the Chinese New Year, in January / February each year. The exact dates of this holiday vary from year to year, depending on the lunar calendar.

Recreation

Most leading hotels and residential centers in the major cities offer sports facilities such as health clubs, tennis and squash courts, jogging tracks and swimming pools. There are also a number of golf courses located in and near the major cities, many of which can be used by paying a green fee.

The PRC is rich in cultural heritage and has many places of interest to overseas visitors. It also has a number of scenic hotel resorts. The leading hotels and travel companies are well equipped to make arrangements for overseas visitors according to their interests.

Eating out is a popular pastime and Chinese cuisine offers a rich variety of styles and regional dishes. Additionally, in the major cities, a number of restaurants offer Western menus of the highest international standard.

Shopping is equally popular. In particular, the Government-owned stores offer a wide variety of products of interest to overseas visitors.

Some useful tips for visitors

It is essential to carry business cards printed in both Chinese and English as these are handed out on all business occasions. These cards should be presented and received with both hands, which is a sign of respect in Chinese custom.

Courtesy and good manners are appreciated by the Chinese and are fundamental in any business discussions and negotiations.

Additionally, patience is a great asset in dealing with life in the PRC. Rudeness and signs of frustration will not get things done any quicker; they may have the opposite effect.

Tipping is not encouraged and by law PRC officials are forbidden to request or accept any gifts from foreigners, except for items such as scientific goods, technical materials, journals, samples, awards or souvenirs.

English and other foreign languages are not widely understood, even in the major cities. It is, therefore, always useful to arrange for the place that you wish to visit to be written down for you in Chinese so that you can show this to, for example, a taxi driver. Most hotels have a readily available stock of cards printed in Chinese indicating the name of the hotel and its address.

Dress codes in the PRC tend to be conservative and high moral standards are expected. The laws of the PRC apply equally to residents and visitors and disciplinary action will be taken if laws or accepted standards of morality are breached.

Western business dress is usual in working life and for business functions while smart casual, conservative style clothing is required for social occasions. Temperatures vary considerably from season to season and throughout the country. It is advisable to check what the weather will be like during your trip and to plan your wardrobe accordingly.

Finally, visitors to the PRC should, in accordance with the customs regulations, declare precious metals, jewelry and other valuable items at the customs point on arrival. If these are not declared on arrival, there could be problems in taking them out of the country on departure.

3. Opportunities for international investors

Since the early 1980s, the PRC has operated an "open door" policy aimed at attracting foreign investment. Its objective is economic development through overseas participation, in particular in principal areas where it considers modernisation is required: agriculture, industry, science and technology.

These areas will continue to provide significant opportunities for international investors. Infrastructure development, which is essential to the PRC's overall economic development program, will generate considerable investment opportunities.

The PRC has further opened its markets to foreign investors after joining the World Trade Organization. The existing restrictions on foreign investment in the tertiary sectors, such as the banking and finance, and accountancy and legal services have been reduced. Certain industries that foreign investments are prohibited, such as telecommunication and internet services, will also be opened up. The extension of national treatment to foreign investors means that the PRC will eventually provide a level playing field to both foreign and domestic investors. The restriction on domestic sales of goods manufactured by foreign investment enterprises will be removed gradually.

To cope with the competition that will emerge after entering the World Trade Organization, the reform of state-

owned enterprises will continue. Foreign investors are encouraged to participate in the reform of state-owned enterprises.

The central government has started to implement the "Development Strategy for the Central and Western Region" since the beginning of this century. In 2003, a set of new circulars were issued with an aim to rejuvenate the old industrial bases in North-Eastern provinces. Economic development of Central and Western as well as North-Eastern regions in China will be the top priorities of the PRC government in the decade.

In summary, the PRC represents a major international investment opportunity both now and in the foreseeable future.

Agriculture

Agriculture is the foundation of the PRC's national economy. Further development of agriculture is seen by the PRC's leaders as the key to overall economic growth. A recent trend has been to extend beyond grain production to the production of cotton, fruit, vegetables, tea and other items in high demand, while also expanding agricultural production geographically from the South to the North. Intensive capital investment is envisaged in this sector involving participation by overseas investors.

Natural resources

The PRC has rich natural resources but these are in varying stages of development. More than 150 kinds of mineral have been discovered and reserves of many of these minerals have already been verified. The PRC's deposits of tungsten, tin, molybdenum, antimony, mercury, lead, zinc, iron, coal, sulphur, phosphorus, graphite, fluorite and siderite are among the largest in the world. Assisting the PRC to exploit these resources presents major opportunities for overseas investors.

Oil and gas

The PRC's offshore areas have been open to international bids for the last ten years and reserves of oil and gas have been discovered. Exploration is expected to continue. In addition, selected inland oil fields are to be explored, particularly in the three basins of Tarim, Turpan and Hami in the West. There will be opportunities for international investors to participate in these projects.

Energy

Coal is the major source of energy for the PRC and its reserves are believed to exceed 700 billion tons. The PRC also has extensive water resources and its rivers have a total hydropower potential of over 600 million kilowatts, half of which is available for exploitation and utilisation. In addition, the PRC is developing nuclear power electricity generating stations. The

Daya Bay nuclear power plant (near Shenzhen) was completed in 1994 with foreign technology assistance and investment. Plans have been drawn up for the construction of both coal-fired and hydroelectric power plants throughout the country. There are opportunities for overseas investors to assist the PRC to further develop its energy sector.

Industrial development

Industrial development in the PRC presently encompasses three main initiatives: improving efficiency in state-owned industries, including corporatisation and privatisation proposals; developing new industries, in particular hi-tech ones, and encouraging foreign investment in Central and Western China as well as the North-Eastern China.

There are various special zones in China: the five Special Economic Zones, the 14 Open Coastal Cities, Economic and Technological Development Zones, the High Technology and New Technology Development Zones, the Shanghai Pudong New Area, the Bonded Zones and Export Processing Zones. The remarkable development of these special zones is a clear demonstration of the success of the PRC's open door policy.

Infrastructure and the service industries

Over the last ten years, the PRC has entered into numerous joint venture projects which have provided for foreign participation in the development of its infrastructure and service industries. Of particular note are:

- construction of numerous hotels and office complexes
- upgrading of the PRC's international airline and airports
- construction of highways connecting major cities and provinces
- environmental improvement projects in major cities
- construction of power plants
- upgrading of telecommunications
- joint ventures with international accounting firms

Infrastructure and the service industries will continue to provide significant opportunities for overseas investors.

4. Forms of foreign investment

The PRC has a number of different methods of facilitating foreign investment. The most common is the foreign investment enterprise. Foreign investment enterprises are enterprises which are established in China wholly or partly (at least 25 percent) by foreign investors. They may be Sino-foreign equity joint ventures, Sino-foreign co-operative joint ventures or wholly foreign-owned enterprises.

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

Processing and assembly agreements

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

In almost all cases, the foreign company will have to supply the necessary production technology, equipment and supervision.

In general, under a processing and assembly agreement, the foreign investor is not allowed to sell any of the goods produced on the domestic market without the approval of the PRC authorities.

Equity joint ventures

Equity joint ventures are limited liability companies with joint PRC and foreign ownership set up for specific purposes such as the establishment of a new manufacturing concern. In general, the foreign partner provides the capital investment, technical expertise and management skills and arranges for technology transfer. The PRC entity makes land and buildings available and facilitates the smooth operation of the joint venture.

The two parties' equity contributions to the joint venture determine their share of the results. Both parties primarily benefit from the exploitation of new business opportunities.

Co-operative joint ventures

Co-operative joint ventures are sometimes referred to as contractual joint ventures. They are similar to equity joint venture but differ in that the obligations of each party are spelled out in a contract. These contracts typically specify the minimum registered capital and capital contributions of each party at various levels of investment and their respective share of the results of the enterprise. A co-operative joint venture can be a legal person with limited liability, if it is so registered.

Wholly foreign-owned enterprises

Wholly foreign-owned enterprises are legal entities in China and are wholly owned by one or more foreign investors. The new *Catalogue Guiding*

Foreign Investments (published in 1995 and the second amendment in March 2002) identifies the industries where wholly foreign-owned enterprises are not allowed.

The biggest advantage of a wholly owned enterprise is that the foreign investor will be able to enjoy full autonomy in managing the company. In some cases, a foreign investor may prefer a wholly owned structure as its trade secrets are better protected.

There are still sectors that restrict the establishment of wholly foreign-owned enterprises. Such restrictions are expected to be relaxed or phased out in the course of continuous improvement of investment environment in the long run. One example is the removal of various restrictions on foreign investment in the distribution sector, including wholesale, retail and import/export, etc. Among the various restrictions, the joint-venture requirement will be removed. Starting from 11 December 2004, wholly foreign-owned commercial enterprises will be allowed.

PRC holding companies

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

The PRC holding company and its subsidiary companies are taxed as separate entities and do not file a consolidated tax return.

A holding company can further apply for "Regional Headquarter" qualification, which has a broader scope of services.

Representative offices

Foreign enterprises may set up representative offices in the PRC. Such offices are not separate legal entities in the PRC. Their permitted business scope is generally very limited; a representative office is prohibited from engaging in business operations.

Branches

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

Construction / installation projects

Effective from 1 April 2004, foreign contractors are no longer allowed to carry out new construction or installation projects in the PRC on a contractual basis. Instead, they will have to set up foreign investment construction enterprises in China, which are subject to the same license administration as domestic construction enterprises.

Sub-contracted business

A foreign company may manage and

operate all or part of the business of a domestic enterprise or a foreign investment enterprise on a sub-contractual basis. The PRC government has implemented plans to reform state-owned enterprises. Foreign companies may sub-contract the business of state-owned enterprises, subject to approval of the PRC authorities.

Overall philosophy and approach

The PRC government has adopted liberal policies to attract foreign investment, guaranteeing independent ownership. Except for certain industries which need to be approved by the central government authorities, such as the Ministry of Commerce, authority to approve the establishment of foreign investment enterprises with total investment under US\$30 million has been delegated to provincial, regional and municipal government. Encouraged investment projects which exceed the threshold of US\$30 million may also be approved by the local levels if the projects do not require the state overall planning control.

The PRC has gradually extended "National Treatment" to all foreign investment enterprises. Certain tax concessions currently enjoyed by foreign investment enterprises will be phased out. In order to encourage technological enhancement, new concessions are introduced to hi-tech industries.

Practical considerations

There is a considerable body of knowledge in Hong Kong based on direct experience of entering into arrangements with the PRC. Most overseas investors find that it is to their benefit to take advantage of this knowledge and experience. The financial services sector in Hong Kong also acts as a catalyst for raising any funds required for large scale projects.

The PRC has a large supply of organisations and relatively low production cost. Various tax concessions are also available to foreign investment enterprises. However, it is essential for potential international investors to view the PRC from a longer-term standpoint rather than just as a source of quick profit with a short pay-back period. A popular misconception is that China is one market and there will be immediate access to a 1.3 billion domestic population. The distribution networks and infrastructure do not yet exist to make transporting goods efficient and the sheer size of the country may preclude this. In addition, certain industries, the tertiary sector in particular, are not fully open up to foreign investors.

KPMG member firms have considerable experience in assisting overseas companies to establish operations in the PRC. Its partners are available to provide any advice and guidance that may be required, including arranging introductions both within the PRC and within the Hong Kong community.

Reform of state-owned enterprises

The government has implemented plans to gradually corporatise China's better run, large and medium size state-owned entities into companies with limited liabilities. The government also aims to improve the debt-assets ratio of the state-owned enterprises by converting debt into equities. Large-scale privatisation is to be made possible through the sale of shares of state-owned enterprises. The state will no longer be the dominant shareholder of these companies except for those in certain strategically important sectors. In 2000, most state-owned entities in 12 industrial sectors reported profits or stopped making losses.

The Shanghai Stock Exchange and the Shenzhen Stock Exchange are the only two official stock exchanges in the PRC. "A" shares and "B" shares are traded on these two stock exchanges. In addition, the shares of the state-owned enterprises selected and approved for corporatisation are to be listed on the Hong Kong Stock Exchange as "H" shares and other overseas stock exchanges such as the New York Stock Exchange.

"A" shares are issued to and traded by Chinese nationals. They are issued and traded in Renminbi.

"B" shares are denominated in Renminbi but are traded in foreign currency. From March 2001, in addition to foreign investors, Chinese nationals with foreign currency can also trade "B" shares.

The program of corporatisation will continue and other state-owned enterprises will be selected to list their shares on the PRC and overseas stock exchanges.

In 2003, China further launched the Scheme of Qualified Foreign Institutional Investors (QFIIs), which provides a new approach for foreign capital to access China's capital market.

5. International trade

Published statistics

The PRC's GDP in 2003 totalled US\$1,406 billion.⁵

The PRC's exports in 2003 totalled US\$438.4 billion, an increase of 34.6 percent compared with 2002, while its imports totalled US\$412.8 billion, an increase of 39.9 percent from 2002.⁶

Its major trading partners are Japan, Hong Kong, the United States of America and the European countries.

Responsibility for international trade

Responsibility for administering international trade rests with the Ministry of Commerce (formerly the Ministry of Foreign Trade and Economic Co-operation).

Foreign investment enterprises are allowed to import equipment for self-use and raw materials for production purposes and to export their self-manufactured goods. Private companies that satisfy certain conditions can apply for the rights to import and export goods.

The PRC operates quota and licensing control over certain imported or exported commodities. The categories of goods subject to quota and licensing control are gradually decreasing. Foreign investors who import into China or export from China are advised to obtain up-to-date information concerning quotas and license controls.

After its entry into the World Trade Organisation, the PRC will gradually remove the non-tariff barriers to trade.

⁵ "Statistical Communiqué on the 2003 National Economic and Social Development", National Bureau of Statistics of China

⁶ 2003 Imports and Exports Statistics, Ministry of Commerce of the People's Republic of China

6. Doing business in the PRC

The principal forms of doing business in the PRC are direct sale or purchase contracts with PRC entities, covering imports, exports and services, and the arrangements referred to in Chapter 4 concerning foreign investment: processing and assembly agreements; equity joint ventures; co-operative joint ventures and wholly foreign-owned enterprises.

Some of the more important points that need to be taken into account concerning such arrangements are discussed below.

PRC laws and regulations

The PRC has made a determined effort over the past ten years to introduce a framework of commercial law which would encourage foreign investment. At provincial, regional and municipal level, regulations have also been introduced to meet the same objective.

The PRC's commercial laws are still evolving in line with the fundamental objective that foreign investment is to be encouraged. KPMG member firm partners are able to introduce lawyers⁷ with in-depth knowledge of the legal system in the PRC to those who wish to obtain further information on this subject.

Contracts and negotiations

Contracts, including foreign economic contracts, are governed by the Contract Law promulgated in March 1999 which took effect on 1 October 1999. Foreign investors often find that

the attitude within the PRC towards business contracts is that contractual documentation should be kept to the absolute minimum and that all business matters can be resolved if both parties adhere to the basic concepts of equality and mutual benefit.

A further generally held view in the PRC is that all business decisions should be the subject of prior discussion and agreement by both parties and that all differences should be settled by a process of conciliation without recourse to third party arbitration or to the courts of law.

Foreigners usually find that their counterparts in the PRC are knowledgeable about the potential investor or trading partner's company, its competitive position and the worldwide situation of the industry concerned. Negotiations are likely to be long and detailed, and it is important for foreigners involved in the negotiation process to demonstrate patience, tact and politeness. Aggressive negotiation tactics are likely to fail.

The Chinese are exacting negotiators and will continue to scrutinise all their options before signing any agreement. The key to success is to identify relatively few negotiating points on which to concentrate and to adopt a flexible attitude on minor contractual issues; the foreign party should accept from the outset that not all its normal

terms and conditions will be acceptable. It should also ensure that there is indeed an agreement rather than merely a statement of intent.

Customs

The PRC General Administration of Customs administers the import and export of goods into or from the PRC. The Customs offices collect customs duty and import taxes (including value added tax and consumption tax) for goods imported into the PRC. Import customs duties were lowered from an average of over 47 percent in 1992 to approximately 10.4 percent in 2004.⁸ According to the PRC government, the average customs duties on imports of industrial products will be lowered to 10 percent by 2005. Goods imported from a country that has a reciprocal preferential tariff agreement are subject to the preferential rates.

The importation of raw materials into the PRC for the production of goods for export purposes is not subject to customs duty and import taxes, but is subject to approval by the Customs authorities. In addition, the PRC has 15 Bonded Zones (or Free Trade Zones) and 38 Export Processing Zones as of September 2003 which are separate customs areas. Goods imported from overseas into these Bonded Zones and Export Processing Zones are not subject to any customs duty and import taxes.

⁷ Not all KPMG member firms are authorised to perform legal services, and those that are so authorised may do so only in their local regions.

⁸ Gazette no. 84, Customs General Administration, People's Republic of China

Export duties only apply to a few commodities, such as certain scarce minerals. There may be considerable disparities in the imposition of import and export tariffs on trading with different countries. Customs duty concessions may also be available to foreign investment enterprises. It is advisable to seek expert advice on PRC customs issues.

The banking system

The People's Bank of China (PBOC) acts as the country's central bank. The 15th National People's Congress held in March 1998 called for a reform of the banking system. The main target of the bank reforms is to strengthen the PBOC's supervisory and regulatory functions and replace the administrative measures by indirect monetary controls in the commercial banking sector.

Since 1 January 1998, the PBOC has abandoned lending quotas for the four state-owned commercial banks – the Bank of China, the Industrial and Commercial Bank of China, the China Construction Bank and the Agricultural Bank of China. Consequently, the four commercial banks have more autonomy over their use of funds. The PBOC also now allows the commercial banks to set their own floating interest rate within a specific range. Since April 2003, China Banking Regulatory Commission (CBRC) has been authorised by the State Council to take over PBOC's approval and monitoring authority governing banks, financial

asset management companies, trust investment companies and financial institutions with deposit business.

Foreign bank branches or foreign-invested banks are allowed to conduct in foreign currency business in all PRC cities. By December 2003, approved foreign banks are allowed to engage in Renminbi business to clients in 13 approved cities. The PRC has further opened the banking industry to foreign investors after it joins the World Trade Organisation. The geographic restriction on Renminbi business will be phased out gradually. The restrictions on doing business with domestic enterprises and individuals will also be removed.

Foreign exchange controls

The official body charged with the management and control of foreign exchange is the State Administration of Foreign Exchange (SAFE) under the People's Bank of China. SAFE is responsible for both formulating foreign exchange regulations and for administering control. All foreign exchange transactions must ultimately be cleared through approved PRC banks.

Foreign investments enterprises operating in the PRC can open foreign exchange accounts with approved banks. All receipts of foreign currencies are required to be deposited in the foreign exchange accounts and disbursements in foreign currencies can only be paid from these accounts.

In general, foreign currency remittances out of the PRC, in respect of international current account transactions, do not require the approval of SAFE. However, remittances for capital account transactions are subject to the approval of SAFE.

The People's Bank of China publishes the unified exchange rate on a daily basis based on market supply and demand.

Domestic organisations (excluding foreign investment enterprises) in the PRC are required to purchase foreign currencies at PRC banks when necessary. Subject to the approval of SAFE, domestic organisations can also maintain a foreign exchange bank account.

Foreign investment enterprises are free to retain their own foreign exchange receipts in the bank account. There is a cap on the maximum amount of foreign exchange that can be retained in the foreign exchange bank account. The cap is determined by the foreign exchange expenditure and foreign exchange revenue level. Excess foreign exchange is required to be sold to the bank.

Payments to and from the PRC

In respect of overseas trade, the most common way of making payments from the PRC is by letter of credit. The letters of credit system closely parallels accepted practices. The PRC is a

member of the International Chamber of Commerce (ICC).

Payments are normally required in foreign currencies for exports from the PRC and services purchased.

Patents and trademarks

Foreign trademarks registered in the PRC are protected by law. The PRC's Trademark Law became effective in 1983, the Patent Law in 1984 and the Copyright Law in 1991. The Trademark Law was last revised in October 2001 and the Patent Law was last revised in August 2000. Since 1988, the PRC has officially adopted the international system for commodity classification and the Vienna system for design elements classification, thus internationalising the PRC's trademark registration and administration.

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

Copyright laws

In recent years, the PRC has been under increasing international pressure to provide greater legal protection for intellectual property rights. The PRC's Copyright Law, which came into force

in June 1991, aims to protect literary, musical, dramatic, audio and visual property.

The PRC was a signatory to both the Berne Convention and the Universal Copyright Convention, the two main multi-lateral copyright conventions. In order to protect the rights and interests of copyright holders of foreign works, the PRC issued the Regulations on Implementation of International Copyright Treaties in September 1992. In addition, supplementary provisions were formulated in order to punish copyright infringements.

Insurance

The insurance business in the PRC is governed by the Insurance Law which became effective in October 1995. The China Insurance Regulatory Commission (CIRC) was established in November 1998 with the broad mandate of supervising and developing the insurance industry.

Chinese insurance companies are allowed to write insurance in the PRC. All foreign investment enterprises and projects contracted by foreign enterprises in the PRC are required by law to be insured with Chinese insurance companies or foreign insurance companies operating in China. They are not allowed to take out insurance outside the PRC.

Foreign insurance company branches and joint venture insurance companies

are now allowed to operate in Shanghai, Guangzhou and Shenzhen. It is expected that the PRC will open up the insurance industry to foreign investors following admission to the World Trade Organisation.

Arbitration

There is a growing recognition in the PRC of the need for arbitration clauses to be written in contracts. In many contracts involving foreign investment it is now provided that if mutual consultation between the parties fails to resolve differences, and if both parties agree, the matter may be referred to the China International Economic and Trade Arbitration Commission. Under the PRC Arbitration Law which became effective in September 1995, foreigners are allowed to act as arbitrators.

Accounting and auditing

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

the PRC, including foreign investment enterprises (FIEs). These regulations standardise the accounting practices for state-owned enterprises and FIEs and bring them more into line with generally accepted accounting practices in Western countries.

In 1994, the MOF started a project involving the development of approximately 30 specific accounting standards. These standards make reference to generally accepted accounting practices in Western countries, such as International Accounting Standards, US GAAP and UK GAAP, and will eventually apply to all types of enterprise in the PRC. The first specific accounting standard was issued in 1997, and 16 had been issued up to July 2004.

In December 2000, the MOF took a further step towards consolidating the accounting rules and regulations adopted in different types of enterprise and issued the Accounting Regulations for Business Enterprises (ARBE). As with the specific accounting standards, the ARBE will eventually apply to all types of enterprise in the PRC.

For the time being, the ARBE applies to companies limited by shares, foreign investment enterprises, and newly established enterprises (i.e., those established on or after 1 January 2003). Upon approval by supervisory authorities, state-owned enterprises can adopt ARBE. Enterprises adopting the ARBE are also required to comply

with all of the specific accounting standards, except the one on interim financial reports, which only applies to listed companies.

The MOF also issued the Accounting Regulations for Financial Enterprises (ARFE) in November 2001 and the Accounting Regulations for Small Enterprises in April 2004, in order to address different business sectors. The ARFE currently applies to all listed financial enterprises, foreign investment financial enterprises, and securities enterprises. Financial enterprises include banking, insurance and securities enterprises.

According to the relevant PRC law, accounting books and records of enterprises must be maintained in the PRC and written in Chinese. If necessary, a foreign language can be added. The accounting year is normally from 1 January to 31 December. The accounting software adopted by FIEs must be approved by the MOF.

It is important for foreign investors to ensure that their joint venture contracts contain provisions for adequate financial control over the joint venture, including an independent external audit of the enterprise's accounts. The annual accounts of FIEs must be audited by certified public accountants registered in the PRC. The PRC government has allowed international accounting firms to establish joint venture firms to perform statutory audits in the PRC. KPMG

Peat Marwick Huazhen, established in October 1992, was the first joint venture accounting firm recognised by the PRC government.

7. Business taxation for foreign investment enterprises and foreign enterprises

Income Tax Law

Chinese domestic enterprises and foreign investment enterprises (as well as foreign enterprises) are subject to different sets of tax laws and regulations. Foreign Enterprise Income Tax (FEIT) applies to both foreign investment enterprises and foreign enterprises. Foreign investment enterprises include equity joint ventures, co-operative joint ventures, and wholly foreign-owned enterprises set up in the PRC. Foreign enterprises which have establishments in the PRC or otherwise have China source income may be liable to Foreign Enterprise Income Tax. The standard FEIT rate is 33 percent. This is made up of state tax of 30 percent and local tax of 3 percent. The state tax rate of 30 percent may be reduced to 10 percent, 15 percent or 24 percent if the enterprises are located in one of the specially designed zones in the PRC and/or engaged in the relevant operations or projects. The local tax of 3 percent may be waived or reduced by the local government. The PRC government has indicated that the two sets of income tax law may be unified in 2006. Some of the existing tax incentives may change.

Incentives

A newly established foreign investment enterprise engaged in production activities with a scheduled operation period of no less than ten years is entitled to a five year tax holiday. Such enterprises are entitled to

full tax exemption for the first two profit-making years and can enjoy a 50 percent tax reduction in the following three years.

A foreign investment enterprise exporting 70 percent or more of its total production value for any year may receive a further 50 percent reduction in tax in that year after the end of the five year tax holiday. However, the minimum state tax rate is 10 percent.

Foreign investment enterprises applying advanced technology may receive a 50 percent reduction in tax for a further three years following the five year tax holiday, subject to a minimum state tax rate of 10 percent.

If the foreign investor in a foreign investment enterprise directly reinvests its dividends in that enterprise or uses the dividends to establish another foreign investment enterprise, it may receive a refund of 40 percent of the state income tax paid on that reinvested amount. The tax refund will be increased to 100 percent if the enterprise is export-orientated or technologically-advanced.

The PRC authorities have announced a series of tax incentives in relation to technology development and innovation. These preferential policies include the bonus deduction of research and development expenses for income tax purposes, and business tax exemption on the transfer of technology. Foreign investment

enterprises may also import equipment for replacement free from customs duty and import value added tax.

Enterprises that acquire domestically sourced equipment may obtain an income tax credit of 40 percent of the cost of equipment. In addition, the value added tax paid for the domestically sourced equipment may also be refunded.

There are various other tax incentives available to foreign investment enterprises which apply to particular industries or particular locations. It is advisable to seek expert advice on this.

Double taxation treaties

The PRC has signed agreements with most of its major trading partners to avoid double taxation of income. Most of these agreements closely follow the Model Treaty of 1977 prepared by the Organisation for Economic Co-operation and Development (OECD), but vary in particulars. By the end of 2003, the PRC had entered into tax treaties with 83 countries/areas.

Value Added Tax (VAT)

VAT is charged on the supply of goods, and the provision of repairs and processing services in the PRC as well as on the importation of goods into the PRC. VAT is charged at each stage of the production of goods and services, with each supplier receiving credit for the relevant VAT he has paid so that VAT is actually borne by the final consumer.

VAT is normally accounted for on a monthly basis. Where input VAT exceeds output VAT in a period, the excess should be carried forward to offset the output VAT in the following periods. No input VAT credits are available on VAT paid on the purchase of fixed assets or for goods or services purchased for the production of non-taxable and exempted goods.

The standard VAT rate is 17 percent but certain products are taxed at 13 percent, or are exempted. Small scale businesses, as defined by the authorities, are taxed at 6 percent or 4 percent without any entitlement to input VAT credits.

Exports are zero-rated. Foreign investment enterprises may claim refund of input VAT in relation to their exports. However, the refund rates vary from zero percent to 17 percent according to commodity. As a result, the goods exported from the PRC by foreign investment enterprises may be subject to VAT.

In order to encourage the development of software and integrated circuit in the PRC, VAT rebates on production and sale of these items are available.

Business tax

All entities and individuals who provide services (except for processing or repair services) or transfer intangible assets or immovable property in the PRC are subject to business tax.

Taxable services for business tax purposes include transportation, construction, finance and insurance, post and telecommunications, cultural activities and sports, entertainment businesses and services. The general business tax rate is 5 percent. For industries such as transportation and construction, the business tax rate may be reduced to 3 percent. However, entertainment services may attract business tax of up to 20 percent.

Consumption tax

Consumption tax is charged on the production, processing and importation of certain luxury or high-end goods. Eleven categories of goods are subject to consumption tax: including tobacco, liquor, cosmetics, skin and hair conditioners, jewelry, firecrackers, gasoline, diesel oil, motor vehicle tires, motorcycles and motor vehicles. The tax rates vary from 3 percent to 45 percent depending on the category of goods. Consumption tax is levied in addition to value added tax. The PRC authorities are considering to expand the scope of consumption tax to certain high-end goods.

Land Appreciation Tax (LAT)

LAT applies to the appreciation in value arising from the transfer of real estate property in the PRC. It is imposed on all entities and individuals, foreign or domestic. The tax is levied at rates varying from 30 percent to 60 percent of the appreciation in value depending on the percentage of appreciation

compared with the cost and other allowable deductions. These are defined in the LAT regulations. Land developers are given additional allowable deductions in computing the appreciation in value.

Customs duty

Customs duty is charged on the importation of goods into the PRC. It is calculated based on the CIF value of imports or based on quantity. The duty rate on a particular type of product is determined in accordance with a tariff schedule. The average duty rate is approximately 10.4 percent in 2004.

According to the PRC government, the average customs duty on imports of industrial products will be lowered to 10 percent by 2005. Preferential rates apply to imports from any country with which China has a reciprocal preferential tariff agreement.

To encourage foreign investment, the PRC authorities have granted customs duty and import value added tax exemption on the importation of equipment into the PRC if certain conditions are satisfied. Foreign investment enterprises may import equipment for self-use free from customs duty and import value added tax. Equipment for replacement purposes may also be imported on an exempt basis.

Importation of raw materials into the PRC for the production of exports can

be exempt from the customs duty and import value added tax, subject to approval of the Customs authorities. The PRC authorities introduced the "import deposit" system from 1 October 1999. Certain enterprises which import certain raw materials for the production of exports may be required to pay an import deposit. The import deposit will be refunded upon the exportation of goods and completion of the customs procedures.

In the PRC, there are Bonded Zones and Export Processing Zones which are separate customs areas. Some of the customs, foreign exchange and tax policies in these Bonded Zones and Export Processing Zones are different from that of other places in the PRC outside these zones.

Withholding tax

Foreign enterprises that do not have establishments in the PRC are liable to withholding tax on their PRC-source income including interest, dividends, rental, royalties and capital gains. Dividends received by foreign investors from foreign investment enterprises are exempt from withholding tax. The withholding tax rate is reduced to 10 percent from 1 January 2000. Tax reduction and exemption are also available under double tax treaties. Withholding tax reliefs may be available if certain conditions are satisfied.

Further information

The PRC tax laws are complex and it is recommended that professional advice is taken prior to entering into arrangements in the PRC. Additional information concerning taxation of foreign enterprises can be obtained from KPMG member firms.

The information set out above is intended as a broad guide only and should not be used for tax planning purposes.

8. Taxation of foreign individuals

The income of individuals in the PRC may be liable to Individual Income Tax (IIT).

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

Residence

Individuals who maintain a permanent home in the PRC are considered residents of the PRC and are liable to IIT on their worldwide income.

Individuals who have lived in the PRC for one year or more are considered to be residents for tax purposes.

However, with the approval of the tax authorities, individuals who have resided in the PRC for five years or less will be taxed on their PRC-sourced income only.

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

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

Taxable income

Income subject to tax includes wages and salaries, business income for sole proprietors, income from contracting or leasing an operation, compensation for personal services, royalties, interest, dividends and bonuses, income from transfer of property and other kinds of income specified as taxable by the Ministry of Finance. Certain non-cash benefits received by the individual, as defined by the tax authority, are not subject to tax.

IIT should be computed separately for each category of income. For foreign taxpayers, a fixed sum of RMB4,000 is allowed to be deducted from monthly wages and salaries which are then taxed at progressive rates from 5 percent to 45 percent. The top tax rate of 45 percent is applicable to monthly taxable income in excess of RMB100,000. As an example, the effective tax rate for a foreign individual earning US\$2,000 per month is about 13 percent.

For income from compensation for personal services, royalties and rents, a fixed deduction equal to the greater of RMB800 or 20 percent of the gross income is allowed. Compensation for personal services, after allowances are deducted, is taxed at progressive rates

from 20 percent to 40 percent. Interest income from bank deposits is taxed at 20 percent or at reduced rates under double tax treaties. Other PRC-source income, after allowances are deducted, is subject to 20 percent IIT.

Further information

As with business taxation, the PRC personal tax laws and the residence rules are complex and it is recommended that professional advice is taken prior to entering the PRC. Additional information concerning the taxation of foreign individuals can be obtained from KPMG member firms.

The information set out above is intended as a broad guide only and should not be used for tax planning purposes.

9. Organisations

Since the PRC adopted its open door policy in the late 1970's, many international companies have moved their organisations intensive operations to the PRC where organisations costs are relatively low by international standards. This has given a tremendous boost to the PRC's economic development.

In the past, workers were assigned to the workplace and there was little or no incentive or any concept of efficiency. However, regulations established by the State Council have now been relaxed and give foreign enterprises greater autonomy in hiring and firing workers. Workers may be recruited through advertisements and other means. Enterprises can interview applicants without obligation and incompetent workers can be dismissed.

In July 1994, the PRC adopted its first organisations law which was made effective on 1 January 1995. The organisations law and rules stipulate that the normal maximum weekly working hours is 40 hours and limits the amount of overtime work allowed. It also entitles workers to organise and join trade unions. There is not a nationwide minimum wage requirement at present. However, wages shall not be less than the minimum wage standards set by the local people's government.

Availability of organisations

Foreign investment enterprises operating in the PRC face little or no difficulty in recruiting PRC nationals for semi-skilled, clerical and supporting posts. However, great difficulty may be experienced in recruiting skilled workers, such as engineers, technicians and managerial staff, as there is still a shortage of such personnel in the country.

Most foreign enterprises use expatriate staff for highly skilled, technical and managerial posts, using Hong Kong in particular as a source for recruitment. Regular commuting between Hong Kong and the Special Economic Zones in Southern China has become a feature of industrial life in Southern China. Similarly, Hong Kong based personnel are frequently employed to take up positions in other parts of the PRC.

As part of technology transfer arrangements, most foreign enterprises have training programs for their workforce in the PRC and overseas assignments for PRC personnel.

Organisations' controls

Within the PRC, strict controls are imposed over the movement of organisations, particularly movement of PRC organisations into the PRC cities.

Foreign investment enterprises are required to submit recruitment plans to

the local Organisations Bureau which then advises on the method of recruitment to be adopted. This usually involves the enterprise issuing a recruitment bulletin through the media or by posting announcements. Enterprises may carry out their own recruitment procedures within this approved framework.

Employment contracts and payment systems

An employment contract system for local staff was introduced in 1986. Under this system, foreign investment enterprises are required to sign employment contracts with their workers, which are then certified by the local Organisations Bureau. The conditions of employment are specified by law.

Foreign investment enterprises can pay wages, bonuses and subsidies directly to their workers. In addition, the enterprises are required to pay for their workers' social welfare and insurance based on a percentage of their wages.

Cost of employment

The cost of employment in China shows a steady rise in recent years and the salary for different working positions varies greatly. As an indication, the average salary in Shanghai is US\$2,670 in 2003, a 13.8 percent increase over that in 2002⁹.

⁹ Notice no.12, Shanghai Labour and Security Bureau

Specific levels of remuneration for various grades of organisations have to be determined from time to time in consultation with the local Organisations Bureau. Incentive bonuses and staff welfare payments are provided for under the PRC's foreign investment laws, which require that a special bonus and welfare fund be created by appropriating funds from the enterprise's after tax profits. This fund is solely for bonuses and other expenses relating to the welfare of the workers.

Foreign personnel employed in the PRC are exempt from the above regulations. The foreign investment enterprises laws do not stipulate any restriction on the number of foreign personnel that can be employed and their employment contracts are usually concluded outside the PRC. Salaries are typically 20 percent to 30 percent above those applicable in their original employment location, for example Hong Kong. In addition, accommodation and per diem allowances are usually provided together with contract conditions that allow short breaks from the PRC, for business or social purposes, in addition to annual leave.

As a broad guide, the total cost of employing foreign personnel to work on long stay assignments in the PRC may be in the region of 150 percent to 200 percent of that in their home base.

Further information

KPMG member firms are able to provide advice and guidance on the availability of organisations in the PRC. They are also able to assist with the recruitment of appropriately qualified and experienced technical and managerial personnel from the Hong Kong market to work in PRC based enterprises.

10. Land and buildings

Land

In the past, land in the PRC has been widely allocated under a system of land use arrangements and no amount is payable to the government by those entities and individuals in possession of these allocations. These entities and individuals do not have the title to the land but merely the right to use the land.

Land use rights can be transferred through business agreements, open bidding or auction and users can apply for extensions of their land use rights when their current rights expire. Transfers are executed by the local office of the State Land Bureau which also coordinates overall plans for land development.

The PRC's laws were amended in April 1990 to regulate the transfer and retransfer of land use rights for state-owned land in the cities and to introduce provincial regulations governing the use of state-owned land for large scale development projects. Under these amendments, both domestic and foreign enterprises can obtain land use rights for fixed periods. These land use right periods are 70 years for housing, 50 years for industrial use and 40 years for commercial use.

Payments for land use rights vary considerably throughout the country. As an indication, the payment for land use rights for already levelled sites for residential development in Beijing was

in the region of US\$850 per square meter in late 2002. The cost for industrial land is comparatively low, depending on the location and facilities available. These payments represent a very substantial increase over those which were required five to ten years ago. Land use transactions in the PRC can be complicated by matters such as legal titles, utilities available and tax on value appreciation. Foreign investors are strongly recommended to take professional advice before entering into any land use transactions; KPMG member firms are able to introduce appropriately qualified and experienced professional firms.

Buildings

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

A number of the larger construction companies in the PRC bid for overseas work and many have been awarded substantial contracts at very competitive prices, for example in Hong Kong and Macau. The PRC also

has a number of leading architects, many of whom have well-established international reputations.

Renting industrial, commercial and office space

The special zones and other cities offer a range of industrial, commercial and office space for rent. The arrangements are similar to industrial parks and export processing zones in other countries.

Industrial, commercial and office space is also available for rent in major cities.

Further information

The property market in the PRC is complex and it is recommended that foreign investors seek professional advice before entering into any rental or lease contracts; KPMG member firms are able to introduce property and real estate agencies with knowledge of the various markets in the PRC.

11. Areas open for foreign investment

Special Economic Zones

Since 1979, five Special Economic Zones have been established in the PRC: Shenzhen, Zhuhai, Xiamen, Shantou and Hainan, all of which are in Southern China.

The authorities of the Special Economic Zones have been given a great deal of freedom to govern the activities within their zones, especially in encouraging investment through special centrally-approved investment incentives. Preferential tax treatment has attracted foreign investments. Foreign investment enterprises and foreign enterprises enjoy a reduced income tax rate of 15 percent.

Projects within the Special Economic Zones currently account for approximately one quarter of the PRC's total enterprises. It is estimated that these zones, which have been developed in a relatively short period of time, now employ in the region of five million workers. The majority of projects in the zones have been concerned with the production of organisations intensive, low technology products such as toys and textiles. However, zone authorities are now making high technology projects their prime objective. For example, Shenzhen has been identified by the State as one of the high technology zones in China.

Open Coastal Cities

In 1984, the PRC designated 14 cities

as Open Coastal Cities and allowed them more autonomy in approving foreign investment projects and offering various investment incentives to attract foreign business.

The 14 cities are: Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Fuzhou, Guangzhou, Beihai and Zhanjiang. Most of them are on the East coast.

These cities now have a wide range of discretionary powers, but they do not, as yet, enjoy the autonomy or degree of preferential treatment granted to the Special Economic Zones.

Open Economic Zones

In early 1985, the PRC classified the Yangtze and Pearl River delta areas and Southern Fujian as Open Economic Zones and later granted similar status to Shandong and the Liaoning peninsula. In 1992, five inland cities and all provincial capitals, except Lhasa, were also granted similar status. These areas are among the most developed in the PRC and are easily accessible.

The incentives granted to foreign investors operating in these Open Economic Zones resemble those of the 14 Open Coastal Cities. Their primary objectives are to encourage technology transfer, management reforms and production inputs between the coastal and interior regions.

Economic and Technological Development Zones

By the end of 2003, the government had permitted 35 PRC cities to set up Economic and Technological Development Zones to encourage advanced industry through foreign participation.

The cities concerned are able to offer a range of incentives aimed at attracting foreign investments. Foreign investment enterprises engaged in production enjoy a 15 percent income tax rate and other favourable operating conditions.

Pudong New Area

In 1990, preferential incentives, similar to those offered by the Special Economic Zones, were granted to the Pudong New Area in Shanghai. The New Area covers 350 square kilometers on the side of the Huangpu River across from the Bund. A customs bonded zone, the Waigaoqiao Bonded Zone, was also established within the New Area in the same year.

Pudong New Area is being developed as a banking and financial center. Foreign investment enterprises in the New Area are allowed to be involved in tertiary businesses such as banking, insurance and retailing. Foreign bank branches established inside the Pudong New Area have been permitted to conduct Renminbi business in certain selected service categories.

New and High Technology Development Zones

At present there are over 50 New and High Technology Development Zones that offer preferential incentives to foreign investment enterprises engaged in high technology industries. The zones offer a reduced income tax rate of 15 percent for hi-tech enterprises. Subject to approval, hi-tech enterprises established within the zones are allowed tax holidays of three to six years. One of the objectives of the zones is to promote the industrialisation of technologies owned by regional universities and research institutes.

Bonded Zones and Export Processing Zones

There are currently 15 Bonded Zones (sometimes referred to as Free Trade Zones) in the PRC. The 15 Bonded Zones are: Shanghai Waigaoqiao, Fuzhou, Xiamen, Guangzhou, Shantou, Shenzhen Futian, Shenzhen Shatoujiao, Shenzhen Yentian, Zhuhai, Haikou, Zhangjiagang, Dalian, Qingdao, Tianjin and Ningbo.

In order to encourage processing trade, the PRC government set up 38 Export Processing Zones by the end of 2003.

These zones are special customs areas. Goods imported into these zones from outside the PRC are not subject to PRC customs duty. In addition, the import license / quota system does not apply to goods

imported from outside the PRC into these zones.

In addition to the special customs policies, special foreign exchange and taxation policies are available in these zones.

Central and Western China

The PRC has announced its blueprint for the development of Central and Western China, local authorities in the Western region have all formulated their own preferential policies, including tax reliefs, to attract foreign investment.

In the course of developing the Western region, China will boost the development the non-state sectors and township enterprises while invigorating the state sector, especially the military industry. This would bring about a host of business opportunities for foreign investors. Priority industries and projects are selected and a special catalogue is prepared to guide foreign investment in these industries. Preferential policies will be available for projects in this catalogue.

Further information

There are various types of special zones in the PRC. Preferential policies, including tax concessions, are available in these regions. Further information on investment incentives and tax concessions, as well as conditions in the PRC's various development areas, may be obtained from KPMG member firms.

12. Hong Kong - one of the principal gateways to the PRC

With effect from 1 July 1997, the government of the PRC resumed sovereignty over Hong Kong. Prior to that time Hong Kong had been a British Dependent Territory for 150 years and now it is a Special Administrative Region of the PRC and has been officially renamed the Hong Kong Special Administrative Region of the People's Republic of China (HKSAR).

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

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

Specifically this means:

- The HKSAR maintains its free trade policy with an open independent

economy, finances and its own legal system and laws.

- The HKSAR remains a separate customs territory. It has separate membership to trade associations and is governed by the rules of international trade (which also apply to trade with the mainland which is deemed to be international).
- There are free flows of capital and no foreign exchange controls. The HKSAR will continue to use the Hong Kong dollar as its official currency.

The HKSAR, therefore, continues to be, among other things, mainland China's window to the world; an easily accessible stepping stone for foreign entities seeking investment in and trade with mainland China. The Hong Kong-PRC partnership has a good track record; the two economic powers have a proven, mutually beneficial business relationship.

Hong Kong's investment in mainland China

Hong Kong is the largest source of overseas direct investment in the mainland. By the end of 2003, among the 465,277 overseas-funded projects registered in the Chinese mainland, 224,509 (accounted for 48.3 percent) were tied to Hong Kong interests. The stock of contracted and utilised capital inflow from Hong Kong amounted to US\$414.5 billion and US\$222.6 billion respectively, each accounting for 44 percent of the national total.¹⁰

The vast majority of this investment has gone into organisations intensive, light industrial manufacturing and the property industry. Through their investment in PRC entities, Hong Kong companies and trading houses provide a means by which foreign companies can initiate discussions with a view to potential trade and investment in mainland China.

Hong Kong companies are also significant investors in infrastructure construction ventures in mainland China. For example Hong Kong companies have a 55 percent holding in the container port at Yantian in Shenzhen and a 45 percent stake in the coal-fired power station at Zhuhai. In practical terms it is, however, difficult to measure Hong Kong's true total investment in China because a lot of the money flowing from Hong Kong is actually held outside China by Chinese citizens who may benefit from preferential tax treatments.

Mainland China's investment in Hong Kong

The PRC holds a major stake in Hong Kong as its third largest investor, after Japan and the UK. In fact, the geographical location of Hong Kong as one of the most important Asian trading centers was an important factor in choosing the location of the Special Economic Zones in the PRC. The proximity of Shenzhen, the most prosperous Special Economic Zone, to Hong Kong is thought to be vital to its ongoing success.

¹⁰ "Economic & Trade Information on Hong Kong", Hong Kong Trade Development Council, 29 July 2004

By the end of 2003, 258 mainland companies (including H-shares, red-chips and other overseas registered Chinese companies) were listed in Hong Kong with a total market capitalisation of US\$217 billion, or 31 percent of Hong Kong's total market capitalisation.¹¹ PRC entities play a critical role in Hong Kong business, for example, the Bank of China Group, is the second biggest banking group in Hong Kong.

Trade between Hong Kong and mainland China

Hong Kong ranked the third largest trading partner of the Chinese mainland after Japan and the US, accounting for 10.3 percent of its total trade in 2003.¹²

Hong Kong is an important market for Chinese made goods. In 2003, it accounted for 17.4 percent of China's exports worth almost US\$76 billion. About half of mainland China's exports are handled via Hong Kong which demonstrates Hong Kong's key role as entrepot as well as trading partner.

In June 2003, the Chinese government and the Hong Kong government signed the Closer Economic Partnership Agreement (CEPA) to accelerate the development of economic and trade relations between Hong Kong and mainland China. Hong Kong firms can enjoy certain benefits than foreign companies can do under the WTO.

Mainland China's principle of national treatment aims to ensure that its business environment is a level playing field for all participants, both native and foreign.

KPMG has offices throughout mainland China in Beijing, Shanghai, Shenzhen and Guangzhou. KPMG partners in Hong Kong and mainland China have a thorough understanding of business in the PRC and a vast network of influential business contacts there.

KPMG member firms can provide you with advice and support on all matters related to investment in and trade with the PRC.

¹¹ "Economic & Trade Information on Hong Kong"; Hong Kong Trade Development Council, 29 July 2004

¹² 2003 Imports and Exports Statistics, Ministry of Commerce of the People's Republic of China; "Economic & Trade Information on Hong Kong"; Hong Kong Trade Development Council, 29 July 2004

Appendix I

Our services in the PRC

A KPMG member firm officially opened an office in Beijing in 1983, followed by offices in Shanghai in 1986, Shenzhen in 1993 and Guangzhou in 1996. Since 1992, the PRC has allowed foreign international accounting firms to establish joint venture accounting firms in the PRC to perform statutory audits and other services. KPMG Peat Marwick Huazhen, established in October 1992, was the first joint venture accounting firm to be recognised by the PRC government. KPMG in Hong Kong coordinates all PRC related activities on behalf of KPMG member firms internationally. Any advice and requests for further information about the PRC should be directed to the partners in our China offices. The contact partners are listed in Appendix II.

KPMG member firm services in the PRC are listed below:

Audit

Accounting and auditing

- financial statement audits
- statutory audits
- providing opinions for other purposes
- accounting advisory services

Tax

Tax and customs

- tax and customs advice and planning
- tax and customs compliance
- liaison with the tax or customs authorities to obtain rulings

Tax compliance

- foreign enterprise income tax returns
- value added tax, business tax and consumption tax returns
- withholding tax returns in respect of payments made overseas
- individual income tax withholding returns

Foreign exchange assistance

- reviewing or advising on the structure of agreements for service fees and cost reimbursements
- applying for tax settlement certificates and tax exemption certificates

Advisory

China market entry

- investigating investment and trading opportunities
- performing due diligence reviews on target companies
- advising on investment structures and entry strategies
- conducting feasibility and market research studies
- assisting in contract negotiations
- assisting in establishing representative offices and foreign investment enterprises
- reviewing joint venture contracts and legal documentation

Other services

- executive recruitment
- joint venture support, including strategic planning; corporate financial services and verification of capital contributions
- advising on the foreign exchange issues and assistance in the remittance of foreign currencies from the PRC
- initial public offerings in Hong Kong, China, the United States and other markets
- secretarial, accounting and bookkeeping services
- assisting banks with the recovery of problem loans

Appendix II

Further information – KPMG contacts

Further information about business in the PRC may be obtained by contacting any of the following partners at KPMG.

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

The material contained in *Investment in the People's Republic of China* draws on the experience of KPMG in China's professionals and public sources of information. While every effort has been made to provide information current at the date of publication, factual statistics concerning China's population, visa requirements, currency rates, etc. change constantly. Accordingly, the material should be viewed only as a general guide and should not be relied on without consulting your local KPMG adviser for specific applications with respect to your own situation.

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