



## Newsletter from Danish-Chinese Business Forum – March 2007



### **Danish-Chinese Business Forum's New Establishment of Sector-based Working Groups. By Tom Jensen**

DCBF intensified its recruitment efforts, initiated two sector-based projects: Branding Denmark in China - Innovation and Knowledge and Food Safety and Fair Wages. The purpose is to make cooperation more directly relevant for members who work in the same industries.

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### **Coping with the Challenges of China's Non-Tariff Barriers. By Svend Roed Nielsen, Undersecretary for Trade Policy and Bilateral Relations, Ministry of Foreign Affairs**

A recent study commissioned by the European Commission shows that China's non-tariff barriers cost EU operators no less than € 21.4 billion a year in lost business opportunities. The European Commission is keenly aware of the problems and have launched several initiatives to address various issues.

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### **Improve on innovation and expand your knowledge base through Denmark's new innovation centre in Shanghai. By Bang Andersen, Ministry of Foreign Affairs of Denmark**

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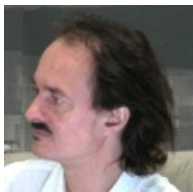
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### **Cultural Differences in Interacting with Chinese Business Contacts. By Verner Worm, Associate Professor, Asia Research Center, Copenhagen Business School**

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### **Culture as a Vehicle to Brand Danish Product and Services the Chinese Way. By Eric Messerschmidt, Director of the Danish Cultural Institute in Beijing**

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### **Tax Analysis - New Tax Enactment of the People's Republic of China. By Deloitte**

The Tenth National People's Congress enacted the new Enterprise Income Tax Law ("New Law") on 16 March 2007 that unifies the income tax treatment of domestic and foreign enterprises.

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### **Kopenhagen Fur Launches Design Center in China**

Kopenhagen Fur has launched a centre for fur design in Beijing jointly with Tsinghua University.

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### **Quick News**

A brief overview of interesting news from China. If you are unable to access the full article please contact DCBF. To view the full article please contact [info@dcbf.dk](mailto:info@dcbf.dk) for relevant links.

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## **Danish-Chinese Business Forum intensifies recruitment efforts. Launch of two new sector-based projects. By Tom Jensen**

*The first sector-based project aims at marketing Danish higher education in China, branding Denmark as a country of Innovation and Knowledge. The second project is about Food Safety and Fair Wages.*

Dear Members,

First of all, I would like to extend a belated xinnian kuaile! February 18 was Chinese New Year, commencing the Year of the Pig, which is known in China for its honesty and pureness of heart.

In the first quarter of 2007, Danish-Chinese Business Forum has intensified its recruitment efforts in order to attract new member companies. At the moment we are just about 95 members and our aim is to reach 120 members by the end of the year. We would therefore like to encourage all our current members to suggest other companies that would have an interest in joining, so that we may expand the network to the advantage of all.

I am pleased to inform you that DCBF has just initiated two sector-based projects:

### **Branding Denmark in China – Innovation and Knowledge**

The first is a campaign to market Danish higher education in China, branding Denmark as a country of Innovation and Knowledge. A task-force has been set down to draft a State-to-State agreement for the Danish and Chinese Ministries of Education (a top-down approach is necessary in China), and to write a catalog of educational programs to be presented to the Chinese Ministries and, eventually, to Chinese universities and their students. The campaign will focus on some of the areas in which Denmark excels internationally, such as business administration, design and engineering.

The project task-force consists of representatives from the University of Southern Denmark, Copenhagen Business School, Niels Brock Business Academy, and Aalborg University. At a later stage of the project, we should like to involve some of our other members who may have an interest in this. With their assistance we hope to find funding for the Chinese students' education through grants and to include traineeships as part of the Danish educational experience. This would also be to the benefit of the member companies participating. One of the many advantages is the possibility of hiring well-qualified Chinese students after they have completed their university degrees and traineeships, either in their main office or in a Chinese subsidiary.

### **Food Safety and Fair Wages**

Secondly, we have initiated a project in Beijing for the improvement of food safety and farmer wages. In cooperation with the Danish Agricultural Council, we are planning a number of seminars about controlling food-quality, and the payment of fair wages to farmers, which primarily will target the Chinese Ministry of Agriculture and the National Food and Drug Administration as well as a number of Chinese universities.

The purpose of these seminars is to find high-level contacts for the participating DCBF members, granting them a high level stamp of approval to help promote the sale of their own products. In addition, it is hoped that the Chinese authorities will become inspired to improve food safety to the benefit of Chinese consumers and export companies. With this focus on quality, the government may be encouraged to improve wage conditions for farmers. The problem today is that Chinese farmers earn low wages regardless of the quality of their products. A governmental emphasis on food safety can therefore contribute to fairer trade. The above two projects are the first step in a new direction that DCBF is taking, namely the establishment of sector-based working groups. The purpose is to make cooperation more

directly relevant for members, who we believe will be better off if working together with companies within the same line of business. We should like your input as to which additional sector groups should be set up. For your information we are already planning to establish a Travel and Tourism group.

**Tom Jensen**

*Secretary General, DCBF*



## **Coping with the Challenges of Chinas Non-Tariff Barriers. By Svend Roed Nielsen, Undersecretary for Trade Policy and Bilateral Relations, Ministry of Foreign Affairs**

*The A recent study commissioned by the European Commission shows that China's non-tariff barriers cost EU operators no less than € 21.4 billion a year in lost business opportunities. The European Commission is keenly aware of the problems and have launched several initiatives to address various issues.*

There is no doubt that China is the biggest trade policy challenge facing the European Union. China's share of global trade has risen with remarkable speed from 1 % at the end of the 1970s to 5 % today. If this development continues at the same pace, China will account for 15 % of world trade by 2030. The EU is already China's biggest trading partner with a total trade turnover exceeding € 200 billion a year.

European consumers and companies have greatly benefited from their access to competitively priced Chinese consumer goods and production inputs. The cheap Chinese goods have contributed to keeping inflation and interest rates at a relatively low level. In Europe, business and the work force have had to adapt to the challenges of China's enhanced role in the globalised world, and this development will undoubtedly continue and intensify as China's manufacturing capabilities become more sophisticated.

Since its WTO accession in December 2001, China has made recognisable progress in liberalizing sectors, introducing and amending laws and regulations and lowering tariffs in line with its accession commitments. However, a complex mix of "behind the border" barriers facing European exporters and investors in China still remains, and this prevents a genuinely reciprocal trading relationship. More often than not, European companies do not encounter a level playing field when trying to penetrate the Chinese marketplace. A recent study commissioned by the European Commission shows that China's non-tariff barriers cost EU operators no less than € 21.4 billion a year in lost business opportunities.

The key obstacles and problems encountered by European companies in China are:

- Intellectual property rights (IPR): In particular lack of or lax enforcement, counterfeiting, trademark and copy right violations and forced technology transfers.
- Norms, standards, and certification requirements and the China Compulsory Certification (CCC).
- Unfair competition.
- Lack of a predictable, transparent, and stable investment climate.
- Equity and ownership restrictions and constantly changing local contents requirements on foreign investment.
- Too much red tape.
- Market distorting subsidies.
- Market access limitations (in particular for services).
- Collusion between local authorities and Chinese business interests.
- Opaque and discriminatory government procurement policies.
- Lack of an effective judicial system.

The European Commission is keenly aware of the problems encountered by European companies on the ground in China, and it has launched several initiatives in order to address the various issues. Following an extensive public consultation, the Commission in October 2006 published a comprehensive policy paper on the relations with China ("EU-China: Closer partners, growing

responsibilities"). It contains an in-depth analysis of the situation and recommendations regarding the issues to be addressed in the context of the Commission's ongoing dialogue with the Chinese authorities, and in connection with the negotiations of a new Partnership and Co-operation Agreement with China, which has already started. The services of the Commission in Brussels and the EU representation in Beijing are also prepared to take up and tackle the day-to-day problems, which our companies are confronted with in China.

As part of the Danish government's globalisation strategy, the Trade Council of Denmark in the Ministry of Foreign Affairs is right now in the process of formulating an ambitious, assertive trade policy, which i.a. will include a business track aiming at the identification and gradual elimination of trade barriers encountered by Danish companies in foreign markets. In this connection, we are collecting input from our embassies and trade offices, the Danish business organisations and companies active in the field.

Once a barrier has been identified, we can address it either with the assistance of the European Commission, or through contacts between our embassies and the authorities of the country in question, or both. On top of that, we can enter into alliances with other countries, or make use of official pressure tools such as non-papers, notes verbales, or letters from ministers.

However, in order for us to be able to take up an issue, it is necessary that we become aware of the problem. Thus, it is of paramount importance that the Danish business community doing business with China informs us about the specific problems encountered in connection with their business operations in China. I encourage you to contact the Foreign Ministry's Office of International Trade Policy and Business (either by mail at [eir@um.dk](mailto:eir@um.dk) or by phone at 3392 0812), or the Danish embassy in Beijing. Needless to say, we will naturally guarantee you full anonymity, if you - for whatever reason - do not want your company's name exposed to the Chinese authorities, or in the EU, when we take the field to promote your company's specific interests.

**Svend Roed Nielsen**

*Undersecretary for Trade Policy and Bilateral Relations  
Ministry of Foreign Affairs*



**Improve on innovation and expand your knowledge base through Denmark's new innovation centre in Shanghai . By Jørn Bang Andersen, Ministry of Foreign Affairs of Denmark**

*In 2006 the first Danish Innovation Centre was established in Silicon Valley, California. And in autumn 2007 the second centre will be established in Shanghai, China.*

In the industrial era oil, coal, steel, iron and other natural endowments were the decisive commodities in the global economy. In today's knowledge based economy, research and science results, patents, trademarks, design and innovation are the decisive commodities.

Basically, there are two ways of acquiring new knowledge. On the one hand, companies and nations may try to produce the needed know-how by themselves. They might on the other hand combine internal production capability of know-how with the deliberate and strategic sourcing of knowledge externally.

Denmark produces around 2 per cent of the global R&D results. Hence, the other 98 per cent has to be found outside Denmark. In 2006, the Danish Government launched an ambitious strategy for Denmark in the global economy. The overall goal of the strategy is to make Denmark the world's most competitive society by 2015.

***The fact that knowledge has become a global commodity has altered the global competitiveness among nations and companies.***

With the establishment of innovation centres in the global economy's hot spots, the Danish government has decided to take a strategic stance towards global sourcing of know-how.

Consequently, the Trade Council of Denmark in the Ministry of Foreign Affairs of Denmark has in concert with the Danish Ministry for Science, Technology and Innovation decided to opt for the combined strategy of both producing and sourcing global know-how. In 2006 the first Danish Innovation Centre was established in Silicon Valley, California. And in autumn 2007 the second centre will be established in Shanghai, China.

The mission of the innovation centres is to strengthen Denmark's innovation and competitiveness by coupling Danish companies and knowledge institutions with leading foreign innovation environments.

So what will be the tasks of the innovation centres? The innovation centres have been established with the purpose of servicing Danish companies, knowledge institutions, public bodies and interest organisations in their global activities. The innovation centres will offer services within the following areas:

- Innovation Watch
- Incubator facility
- Technology Search
- Innovation Partnering
- Biz Innovation Review Board
- Venture Capital
- Investment Promotion
- Branding Denmark

The innovation centre in Shanghai will be open to any Danish company or institution wishing to do business with China. The guiding principle behind the innovation centres is to assist Danish companies and institutions in getting easier access to relevant know-how and a foot-hold on global markets. The financing of the innovation centre in Shanghai will partly be based on customers' paying for the services and partly on government funding for non-commercial activities; e.g. university-to-university contacts.

With the establishment of its second innovation centre in Shanghai, the Trade Council of Denmark has taken a bold step in securing Danish companies and institutions novel ways to make linkages with Chinese innovation environments and knowledge producers.

The Danish Innovation Centres in Shanghai and Silicon Valley offer their users new and unique opportunities for getting access to knowledge and innovation partners in the US and China on preferential terms. If you are interested in learning more about us please contact us at the address below.

*For further information about the Danish Innovation Centres in Shanghai, (China), Silicon Valley (US) please contact The Ministry of Foreign Affairs of Denmark, Trade Council of Denmark, Innovation Unit +45 33 92 13 90 or email [inn@um.dk](mailto:inn@um.dk)*



*Photo: Nanjing Road Commercial Street, Shanghai, P.R.China*



## **Cultural Differences in Interacting with Chinese Business Contacts. By Verner Worm, Associate Professor, Asia Research Center, Copenhagen Business School**

*The cultural differences between Denmark and China is still an area that companies and individuals are struggling with. Understanding the differences between our western, analytical approach and the Chinese holistic approach makes it possible to explain a whole array of cultural differences.*

The cultural differences between Denmark and China is still an area that companies and individuals are struggling with. My own approach has been to dig into the difference between our analytical tradition and the more holistic approach that dominates the Chinese tradition. Never forget the yin-yang symbol, which is the symbol that best characterizes the Chinese mentality. "One time Yin, One time Yang, this is Dao" (The Way) as it is stated in the Book of Change (Yijing). Yin and Yang form two contradictory, interdependent principles evoking the harmonious interplay of opposites in the universe. Based on this simple exploration of Chinese philosophy, it is obvious that we cannot expect western logic to function in an eastern setting, but it is difficult for us to realize that logic is culturally infused and it is understandable that we react by shaking our head and thinking that "this does not make sense". As will be demonstrated in this article, business is doable in China as we know, but it takes some effort to familiarize ourselves with the Chinese mindset. Already here it should be mentioned that the level of familiarity needed depends on the business. Obviously it requires more cultural understanding to own a company in China with Chinese employees than simply importing goods.

Dao - The Way

The Book of Changes (Yijing)



*YiJing is the oldest of the Chinese classical text. It describes an ancient system of philosophy that lies at the heart of Chinese cultural opposites (Yin & Yang), the evolution of events as a process and acceptance of the unavoidability of change.*

Understanding the differences between our western, analytical approach and the Chinese holistic approach makes it possible to explain a whole array of cultural differences. For example, why it does not work to use the western way of negotiating sequentially and solving the problems one by one. The Chinese way is to put all the problems on the table and negotiate a package where all issues are solved at the same time. Using this more holistic approach also explains why it can be so difficult to reach a conclusion. If one issue changes, the whole situation changes and the entire negotiation process will have to start all over again. Where we tend to separate issues or problems, the Chinese tend to focus on the context or the relationship. Nisbett showed Chinese and North American children a picture of a hen, a cow and grass and asked which two belong together. North American children tended to choose the hen and the cow because they both belonged to the category of animals, whereas Chinese children tended to choose cow and grass because the cow eats grass. (Cited in Lynton, N & Thøgersen, K. (2006) How Chinese transform an executive's mind. *Organizational Dynamics* 35(2) 170-181. See also Nisbett, R. (2005) *The Geography of Thought*. London: Nicholas Brealey.)

### **Relations**

Another related issue is that Chinese tend to define themselves in relation to others (interdependent self) whereas we define ourselves independent of others.

A story from my own life is about managing to set up a meeting with a particular Chinese business person. If for example I want to have a meeting with Manager Wang, whom I do not know, what can I do? He will decline if I simply call him, because I am a stranger. The Chinese differentiate more than we do between in-group and strangers (out-group). My way of getting around such a situation is to call my friend Mr. Sun (who might have a connection that can help establish the contact) and ask him what to do. He will normally ask me to wait an hour or so and then he will call me back. He will then tell me that now I can phone Manager Wang and say that Ms. Lin has introduced me. This is a strange situation for me as a westerner, because I do not

know Ms. Lin and I was somewhat hesitant the first time. But as it turned out there was never a problem. When I called Manager Wang, he would immediately say that he knew I would be calling and ask me what he could do for me. This is how a network-based society works.

A student from Hong Kong, who had an internship in a Danish company, described how she felt that no one in the company showed her much concern, compared to what she was used to from Hong Kong. She was greeted quickly on her first day and after two weeks someone happened to ask why she did not have an email yet. She had anticipated that the company would arrange this for her as they would have done in Hong Kong. Another story she told was that she had been invited to a Friday evening party in the company. Everybody was having a good time, but nobody talked to her. She did not really complain but it was clear that she preferred the Chinese way where colleagues will always show special concern to someone who is new in the company.

The reason I tell these random stories is that it is very easy for Danish companies to create goodwill among employees by being a little more "patriarchal" and show some interest in the person. In a particularistic society like the Chinese, people relate to each other specifically. A recent study showed that the main reason talented employees changed jobs was an unsatisfactory relation with their supervisor!

### **Time – Giving Face**

We often feel that the above type of activities is too time consuming, and it cannot be denied that they take time. If you are based in China some of these activities can be outsourced to middle management, but for those of us travelling to China now and then, it is necessary to spend time with customers or employees. Although it is almost 20 years ago, I am sure that we won several contracts in competition with others mainly by spending more time with the Chinese customers than our competitors. There is still money in relationships, but as always, one should show cultural empathy. It gives face and prestige to have contact with the top management from Denmark. At the very least, avoid the situation where the expatriates have lunch at one table and the Chinese management at another.

If you are coming to China often, find something that you like in China (food, China's long history, China's dynamic economic environment etc.) and express it. The Chinese build goodwill or give face by praising each other and you can easily do it as well.

### **Communication**

The Confucian tradition still plays a very important role in China. Chinese communication style is different from ours and many misunderstandings have occurred. In China, keeping the harmony is more important than telling the truth. Be aware that the Chinese do not feel that they lie when they act according to the Confucian tradition. They do the right thing by helping each others.

Chinese people communicate in a much more indirect way than we do and they are often offended by our direct way of asking questions. Having worked with Chinese people for 30 years, I still show my question guide to a Chinese before I use it, so that questions which are too direct can be reformulated.

Let me give an example of typical Chinese - Western (mis)communication:

“Mr. Jones: It looks like we're going to have to keep the production line running on Saturday.  
Mr. Wu: I see.  
Mr. Jones: Can you come in on Saturday?  
Mr. Wu: Yes. I think so.  
Mr. Jones: That'll be a great help.  
Mr. Wu: Yes. Saturday's a special day, did you know?  
Mr. Jones: How do you mean?  
Mr. Wu: It's my son's birthday.  
Mr. Jones: How nice. I hope you all enjoy it very much.  
Mr. Wu: Thank you. I appreciate your understanding.”

As clear as it is for Mr. Wu that Mr. Jones has accepted his request for not coming to work Saturday, it is equally clear for Mr. Jones that he will come. Actually it is also clear for us when

we read it slowly that Mr. Wu is not coming, but in a hectic work situation we react as we would do in Denmark. Listen carefully and you will get the point!

The examples I have mentioned in this short piece can easily be supplemented by stories based on your own experience in China or when you have guests from China. By the way, remember to pick them up in the airport. By doing this you create a goodwill that would have taken days to build around the negotiation table.

To deal with Chinese is not difficult, but you can do your business a favour by adjusting a little to their way of doing things. Finally, remember that the Chinese also have different personalities, so what I have done here is to painted with broad strokes that may turn out to be wrong when applied to a particular person.

**Verner Worm**

*Associate Professor*

*Asia Research Centre*

*Copenhagen Business School*

***Associate Professor Verner Worm, Asia Research Center, Copenhagen Business School is offering the following presentations to the business community about China:***

***How to overcome cultural barriers in China?***

***Where is China heading (economic and political development)?***

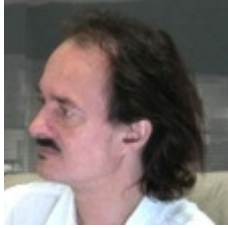
***How to develop a business strategy for China?***

***How to optimize negotiations with Chinese counterparts?***

***Honorarium Dkr 7.000 + travel expenditure outside Copenhagen***

***The sessions typically take two - three hours including questions.***

***Contact: [vw.int@cbs.dk](mailto:vw.int@cbs.dk) or tel. 41560488 (mobile)***



## **Culture as a Vehicle to Brand Danish Product and Services the Chinese Way. By Eric Messerschmidt, Director of the Danish Cultural Institute in Beijing**

*The Danish Cultural Institute in Beijing can be seen as the mid wife for those Danish companies who choose to work in China. Established as a wholly foreign owned company in 2005, it is licensed to work with cultural exchange and consultancy as one of currently four foreign centers on the Chinese territory.*

In the Chinese context which puts emphasis on friendship and mutual exchange as the way to establish lasting relations between people, participation in cultural activities is considered a proof of societal commitment and as such highly estimated. As such, the Danish Cultural Institute in Beijing can be seen as the mid wife for those Danish companies who choose to work in China. Established as a wholly foreign owned company in 2005, it is licensed to work with cultural exchange and consultancy as one of currently four foreign centers on the Chinese territory.

The activities of the Institute are concentrated on

- Presenting concerts and stage performances with Danish soloists and ensembles
- Organizing exhibitions with subjects such as art, architecture, education and social conditions
- Holding conferences and seminars about culture or social studies
- Organizing study tours to and from Denmark and China on subjects as health and social matters, educational and cultural politics. The study tours are mainly aimed towards professional organizations, governmental, regional and local authorities and associations.
- Organizing job-swaps as an international exchange and in-service program for employees within the areas of education, culture and health.

Besides serving and facilitating the continuous exchange between Danish and Chinese cultural stakeholders, The Danish Cultural Institute puts priority on topics which expose Denmark as an innovative and cutting edge nation with a cultural approach founded on encounter and respect. It's not least thanks to its cultural profile and reputation that Denmark manages to hold more attention amongst Chinese than its actual size and economic impact account for.

Typical topics include cultural management, physical and social processes in urban transformation, design as a daily commodity, monitoring of the cultural heritage as well as education aiming at both children level and the grey gold. The key words for these activities are exchange, dialogue and mutual inspiration which can lead to long lasting connections and encourage networks. For this reason, projects and events are carried through in close collaboration with Chinese partners, notably on the media side so as to ensure a maximum dissemination with Chinese audiences.

Like Hans Christian Andersen, Danish cultural life always seeks new paths to travel, new worlds to explore, new technologies to study. And The Danish Cultural Institute sees it as its primary mission to help Danish creative business find the right partners who treasure the niches of the global market by focusing on quality rather than quantity.

### **Eric Messerschmidt**

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## **Tax Analysis - New Tax Enactment of the People's Republic of China. By Deloitte**

*The Tenth National People's Congress enacted the new Enterprise Income Tax Law ("New Law") on 16 March 2007 that unifies the income tax treatment of domestic and foreign enterprises.*

The Tenth National People's Congress enacted the new Enterprise Income Tax Law ("New Law") on 16 March 2007 that unifies the income tax treatment of domestic and foreign enterprises. The New Law consolidates the Enterprise Income Tax Law (EIT), applicable to domestic Chinese enterprises, and the Foreign Enterprise Income Tax Law (FEIT), applicable to foreign enterprises and foreign invested enterprises (FIEs).

While both Chinese domestic companies and FIEs benefit from tax incentives, those applicable to FIEs are significantly greater, thus causing FIEs to pay on average an income tax of around 15%. This compares to an average income tax rate for domestic companies of almost 25%. The New Law, which becomes effective on 1 January 2008, will end the differing EIT and FEIT tax and incentive systems and create a level playing field for all enterprises in China. The New Law provides for a 25% rate (down from 33%) that applies to both domestic and foreign-funded enterprises and, subject to transition relief, enterprises that have enjoyed preferential treatment. The tax rate for domestic enterprises will be reduced, whereas the rate for enterprises that have enjoyed preferential treatment will be higher, unless the enterprise can qualify for a reduced 15% rate applicable to new and high-technology enterprises. Overall, however, the New Law will make the tax system more transparent, stable and predictable - a favourable development for all market participants.

Below is a summary of the main features of the New Law, its impact, and certain issues and planning points.

### **Balancing Competing Goals**

The New Law attempts to balance the sometimes competing goals of encouraging and attracting foreign and domestic investment, spurring economic development and innovation, enhancing tax administration and achieving tax justice. The New Law not only responds to the appeal from domestic enterprises for balanced taxation and fair competition, but also provides some relief to FIEs for the loss of certain of their incentive benefits. Finally, the New Law balances the government's financial revenue needs with the goal of keeping China's tax environment internationally competitive.

### **Fairness and Competitiveness**

Under the two current systems, the actual tax burdens for domestic enterprises and FIEs differ substantially due principally to strict deduction limitations applicable only to domestic enterprises and significantly varying tax incentive regimes. Under the New Law, in addition to a single tax rate of 25%, domestic enterprises and FIEs will be eligible for the same incentives and will be subject to the same rules on deductions.

The new unified tax rate of 25% has been consciously set to be lower than the average tax rates of neighbouring countries. The intent is to maintain China's attractiveness to investors while recognizing the current economic environment that is attracting investors to China for both low-cost labour and access to the country's vast internal market.

### **Concepts in the New Law**

As part of its multi-year effort to reform its tax system, the government carefully studied the tax laws of many other countries. As a result of this examination and careful drafting, the New Law is more organized than its two predecessor laws and has greater clarity and transparency.

The New Law clarifies the definition and scope of gross income, nontaxable income and deductions. It also details withholding at source, tax collection and administration procedure. These features will help standardize tax administration for the tax authorities and taxpayers, should lower the

costs of tax collection and, in general, make for a more transparent and stable tax system.

Although the bulk of the New Law is based on the original tax system, it includes a number of international taxation concepts that are wholly or partly new to China. These include:

- **Residence**—The “managed or controlled” concept to define tax residence will allow the authorities to tax the worldwide income of any non-Chinese company that is managed or controlled in China, and is therefore a tax resident of China.
- **Controlled Foreign Corporations (CFCs)**—Resident enterprise shareholders of certain low-taxed foreign enterprises will have to include in their taxable incomes their respective shares of the profits of such CFCs.
- **Cost Sharing Agreements**—Enterprises and their related parties will be able to enter into cost sharing agreements for the joint development of intangible assets.
- **Thin Capitalization**—Until now, the capital structuring of FIEs has been affected by certain exchange control rules. The thin capitalization rules will add a new layer of regulation for FIEs planning related party borrowings. Domestic enterprises, which have not had foreign exchange issues in their related party dealings, already have been subject to a thin capitalization concept. Now, both domestic enterprises and FIEs will be covered by one new thin capitalization rule.

**Deemed Paid Foreign Tax Credits**—A resident enterprise directly or indirectly holding shares of foreign enterprises will be eligible for tax credits for its proportionate share of taxes paid by such foreign enterprises from which it receives foreign-sourced dividends.

The inclusion of these items, while harmonizing China with other countries, will also create initially some administrative challenges as Chinese tax officials gain an understanding of the meaning and impact of the new concepts.

### **Incentives to Achieve National Objectives**

Through a complete redesign of tax incentives, the government has consciously directed tax policy to achieve certain national economic, social and environmental objectives. This new approach represents a clear shift away from the broad benefits previously available for manufacturing generally, and for specific locations. For example, recognizing the national long-term objective of increasing innovation in China, the New Law focuses on technology, both through a low 15% tax rate available to certain new and high-technology enterprises regardless of where the enterprise is located, and through reaffirmation of the super deduction for qualifying R&D expenses.

Other incentives apply to:

- Encouraged industries;
- Certain venture capital enterprises;
- Certain major infrastructure, environmental and agricultural projects;
- Encouraged industries in the Western region; and
- Certain labour and welfare services.

The trends reflected in the New Law are clear. There is a shift

- (i) from granting incentives only in special regions to the entire country;
- (ii) from a regional development orientation to an industry orientation; and
- (iii) from an export-oriented economy to a domestically driven economy.

## **Strengthening Tax Administration**

The New Law gives the tax authorities a stronger hand in assessing and collecting taxes. In addition to the introduction of the “managed or controlled” concept of residence, CFC and thin capitalization rules, other provisions include:

- General Anti-Avoidance Rule—Contracts and other arrangements without commercial viability may be disregarded by the tax authorities;
- Transfer Pricing Rules—Emphasize on annual filing requirement and mechanisms for advance pricing agreements; and
- Penalties—Specific requirement of a late payment surcharge.

## **Impact of the New Law**

The new environment will affect enterprises differently depending on their particular situations.

### ***FIEs and Foreign Investors***

As many FIEs have enjoyed low effective tax rates due to the broad incentive system, implementation of the New Law should increase the tax burdens of FIEs as a whole. The significance of this overall increase will depend on how broadly the authorities define the category of new and high-tech companies that will be granted the 15% tax rate. If this category is broadly defined, more FIEs may be able to enjoy a low effective tax rate.

The New Law will affect FIEs’ decisions and choices regarding their business model, investment structure, site selection and financing strategy. Until now, foreign investors and FIEs have relied heavily on the broadly granted tax holidays that typically make China a low-tax country for many. Under the new approach to tax incentives, this is no longer a sustainable long-term strategy.

Therefore, FIEs and foreign investors should be developing strategies that optimize global tax benefits and rely more on traditional international tax planning tools such as intellectual property planning, tax-aligned supply chain planning, transfer price planning, etc. With the abolition of geography-oriented tax incentives, the key drivers for site selection will shift from tax incentives to operating factors such as proximity to natural resources and local markets, human resources, etc.

In addition to the loss of tax holiday and reduced rate benefits, some withholding tax rates may increase, thereby affecting foreign enterprises. Although there has been no official indication on specifics of rate increases, the following is possible:

- Dividends—A 20% withholding tax on gross income could be imposed, although a 10% rate is likely. In addition, as there is no mention of the dividend reinvestment tax refund in the New Law, this benefit likely has been abolished.
- Interest, royalties, rentals, service fees, etc.—A 20% withholding tax on gross income could be imposed but a concessionary 10% rate may apply generally.
- Engineering and labour services—A 25% withholding tax based, we believe, on net income could be imposed.

### ***Domestic Companies***

The nominal tax rate applicable to domestic enterprises will drop from 33% to 25%, and the New Law eliminates the deduction limits on certain costs and expenses that have been applicable only to domestic enterprises. As these limits have applied to such significant items as deductible wages and advertising, many domestic enterprises will have major reductions in their tax burden. The new level playing field will help to reduce the practice of “roundtripping”, whereby domestic enterprises take advantage of the incentives applicable to FIEs by transferring domestic capital

overseas and then making inbound investments. Meanwhile, the new provisions on the indirect foreign tax credit and CFC rules will affect the manner in which outbound investments are made.

### **Industries**

The implementation of the New Law will stimulate the development of high-tech, infrastructure, agriculture, and many other industries.

Meanwhile, simple production and processing industries, driven mainly by cheap labour, will be under pressure to upgrade their technology and labour productivity. The issuance of the New Law reduces the tax rate for a large segment, including general service and real estate enterprises, which will facilitate their development.

### **Regions**

The New Law abolishes the existing tax incentives for FIEs in special regions. On the one hand, it decreases the attractiveness of these special regions to FIEs and may, in some cases, result in the relocation of FIEs to regions where they can better achieve their business objectives. On the other hand, the changes will stimulate many of the special regions to improve their overall investment environment and local incentives so as to retain existing investments and attract new investments.

### **Challenges and Opportunities**

The New Law creates many challenges and opportunities for existing enterprises and investors as well as for those that still are in the planning stage. The following are a few areas where attention is required.

#### 1. Tax resident

With the introduction of the "managed or controlled" concept, care must be taken whenever foreign enterprises are managed or directed from China. This can affect not only domestic individuals and enterprises, but also potentially multinationals that have moved management and regional headquarter functions into China.

#### 2. Thin capitalization

The new thin capitalization rules will require heightened attention to the financing and capitalization of enterprises.

#### 3. Transfer pricing

The New Law strengthens transfer pricing administration. Enterprises will be required to file information related party transaction to the tax authorities when conducting annual income tax filing. During transfer pricing audit conducted by tax authority, not only the audited enterprise but also its related party would be required to provide information for the investigation. The new law specifically allows enterprise to use advance pricing agreement to mitigate transfer pricing risk for related party transaction.

#### 4. Cost sharing

The recognition in the New Law of the legitimacy of cost sharing arrangements provides a solid basis for considering the co-development of intangible assets among related parties.

#### 5. Tax incentive and transition arrangements

With the significant changes to the tax incentive system and the transition rules, enterprises and their investors should consider how to utilize the new policies properly and efficiently. For example:

- Enterprises should review their status to determine whether they are qualified as high-tech companies or whether a restructuring would enable them to qualify for at least a portion of their activities;

- Investors considering new projects should do the same regarding their planned operations;
- Enterprises and their investors should study how to utilize the tax incentive for R&D activities;
- Enterprises should fully evaluate the impact of the five-year transition rules; and
- Enterprises and their investors should reassess their site selection strategies to develop the optimal package of operational and tax benefits.

## 6. Outbound investment

The CFC rules will significantly affect enterprises that have made investments outside China. As such, enterprises holding such investments must review the potential effects of the new rules and consider whether any restructuring might be beneficial. And when new overseas investments are considered, planning for the CFC rules and the new indirect tax credit will be essential.

### **Our China Enterprise Tax Reform Series**

The above are only a few of the issues and opportunities under the New Law.

Future issues of China Enterprise Tax Reform Series will expand on areas of interest to enterprises and investors, and will cover some of the above topics as well.

Deloitte initiated in February the China Enterprise Tax Reform Series Issues already or to be soon addressed in this series include:

- Issue 1—Early February: A number of tax planning points, some of which were time-sensitive
- Issue 2—Early March: The direction of Chinese tax incentives and planning for incentives
- Issue 3—Mid-March: Our initial analytical thoughts on certain areas affected by the New Law

If you have not seen all issued publications, you can access them at the following Deloitte websites:

English Website:

<http://www.deloitte.com/dtt/article/0,1002,cid%253D149253,00.html>

Deloitte China:

<http://www.deloitte.com/dtt/home/0,1044,sid%253D7052,00.html>

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## **Kopenhagen Fur Launches Design Center in China**

*Kopenhagen Fur has launched a centre for fur design in Beijing jointly with Tsinghua University.*

Kopenhagen Fur has launched a centre for fur design in Beijing jointly with Tsinghua University today, with an official opening reception in Beijing attended by representatives of Kopenhagen Fur, Tsinghua University, the Danish ambassador to China as well as members of the Danish, Chinese and international press.

The new Chinese design centre, Kopenhagen Fur Studio, will work closely with the existing Kopenhagen Studio in Copenhagen to provide Chinese design students with opportunities to experiment and further develop designs in fur.

Tsinghua University is China's leading university with 30,000 students from all over China. Admission to the University is highly competitive with more than 17,000 candidates each year applying for just over 200 annual admissions at the academy of art and design. Graduates from the academy have a strong impact on the Chinese fashion industry and Chinese design.

In addition to providing skins and assigning furriers to assist the training at the academy, Kopenhagen Fur will invite professors to visit its Copenhagen headquarters for training. To further demonstrate its commitment to support the Academy's efforts in educating world-level designers, Kopenhagen Fur also sets up a scholarship to award four students of outstanding scholarly performance every year.

## Quick News

A brief overview of interesting news from China. If you are unable to access the full article please contact DCBF. To view the full article please contact [info@dcbf.dk](mailto:info@dcbf.dk) for relevant links.

### National People's Congress:

- China's New Property Law a Lightning Rod

The proposed property law, which had been kicking around for 14 years, was passed by a wide margin by the national legislature in March.

To an influential group of retired communist officials and scholars, however, the legislation is a threat to the state's guiding role and a vehicle for unrestrained privatization they contend will feed a growing income gap between rich and poor.

<http://www.guardian.co.uk/worldlatest/story/0,-6484864,00.html>

Source: Guardian.co.uk March 16., 2007

- What China's New Property Law Means

In providing the same level of protection for private and state-owned assets, the country has taken a huge step towards fundamental fairness, says Li Datong. Without such a move, other rights are baseless.

[http://www.opendemocracy.net/democracy/datong\\_fairness\\_4451.jsp](http://www.opendemocracy.net/democracy/datong_fairness_4451.jsp)

Source : opendemocracy.net, March 21., 2007

- Wen Jiabao Stresses Green Growth, Rural Welfare

China will do more to save energy and cut pollution in 2007 while striving to keep its economy humming following four straight years of double-digit growth, Premier Wen Jiabao said to the National People's Congress.

[http://today.reuters.com/news/articlenews.aspx?type=worldNews&storyID=2007-03-05T083442Z\\_01\\_PEK277354\\_RTRUKOC\\_0\\_US-CHINA-PARLIAMENT-WEN.xml&WTmodLoc=NewsHome-C3-worldNews-2](http://today.reuters.com/news/articlenews.aspx?type=worldNews&storyID=2007-03-05T083442Z_01_PEK277354_RTRUKOC_0_US-CHINA-PARLIAMENT-WEN.xml&WTmodLoc=NewsHome-C3-worldNews-2)

Source: Reuters, March 5., 2007

### Taxation:

- China to End Tax Break for Foreign Firms

The tax honeymoon for foreign investors in China is ending even as military spending continues to rise. For two decades, China has rewarded new investors with hefty tax breaks, helping to lure \$659 billion (R5 trillion) in investment that has helped make it the fourth-largest economy, but fuelling complaints by Chinese firms of unfair advantage.

<http://www.busrep.co.za/index.php?fSectionId=&fArticleId=3714027>

Source: Business Report, March 5., 2007

### Regional:

- North Korea Seeks Economic Zone Near China

North Korea is seeking to establish a special economic zone on islands bordering China, Seoul news reports said Friday.

The communist North has been pushing to set up a free trade zone on the Bidan and Wihwa islands on the Yalu River on the western border between North Korea and China, according to Yonhap News Agency.

[http://www.upi.com/InternationalIntelligence/n\\_korea\\_seeks\\_economic\\_zone\\_near\\_china/20070323-060508-3711r/](http://www.upi.com/InternationalIntelligence/n_korea_seeks_economic_zone_near_china/20070323-060508-3711r/)

Source: United Press International, March 23., 2007

### **Stock Market:**

- China Stocks at New High After Seesaw Session

Chinese stocks seesawed through an erratic session Friday as investors are jittery about the direction after the market is at an all-time high.

[http://www.chinadaily.com.cn/china/2007-03/23/content\\_835267.htm](http://www.chinadaily.com.cn/china/2007-03/23/content_835267.htm)

Source: China Daily, March 23., 2007

### **Banking:**

- Bank of China Profit Soars 65 %

A strong rise in profit at Bank of China, the smallest of China's top four banks, provides the latest confirmation of the robust state of the economy, and also reveals the extent to which policy changes can help boost the bottom line of Chinese corporations.

[http://www.forbes.com/markets/2007/03/23/boc-earnings-china-markets-equity-cx\\_jc\\_0322markets1.html](http://www.forbes.com/markets/2007/03/23/boc-earnings-china-markets-equity-cx_jc_0322markets1.html)

Source: Forbes.com, March 23., 2007