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ANNUAL MINISTERIAL BRIEFINGS ON CHINA'S ECONOMIC DEVELOPMENT & FOREIGN INVESTMENT POLICIES

In This Issue :

Interviews with the Ministry of Commerce, Ministry of Finance, State Administration of Tax, General Administration of Customs, National Reform & Development Commission, China Securities Regulatory Commission, China Banking Regulatory Commission

Updates on Chinas New Income Tax Unification, Labor Law, Property Law and their impact on Foreign Investors

May

Chris Devonshire-Ellis
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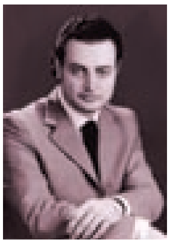

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Vice-Publisher, China Briefing

Welcome to this issue of China Briefing

Welcome to this May issue of *China Briefing*. In this issue we illustrate our recent annual series of meetings with various Chinese Ministries and Senior Officials to try and get a picture of what is happening in terms of economic development in China, the development of the nation, and the impact this is likely to have on foreign investors in the country. This years meetings were highly informative and should provide useful pointers for investors in terms of their ability to assess where their businesses should be going and aiming for in the next decade. We complete the issue with an overview of some of the recent regulatory changes that affect foreign businesses in China in the tax, labor and property areas. As always, the work in this issue has been conducted by Dezan Shira & Associates, China's largest independent business advisory and tax consultancy. For more information about their services, please visit the firm at **www.dezshira.com**.

Finally, we would like to confirm that yes, Dezan Shira & Associates are establishing practice operations in India, with offices in Delhi, Bombay and Chennai about to open any day now. Check the India Desk section on the firms website homepage for more details, and look out for our sister magazine, India Briefing, to be launched next month.

With best regards;

Chris Devonshire-Ellis

Alberto Vettoretti

This Month's Cover Art

This months cover, titled "City In Dust" is by Shanghai artist Zhao Dewei, whose work expressively captures the gritty realities of urban life within the massively and rapidly changing environment of present day China. The sheer, overwhelming scale of the urbanization process within China, which is explored by the artist, is most probably faster and certainly on a grander scale than anywhere else in the world today. We as a viewer can find these elements strongly reflected in the artist's choice of topic and abstract expressionist technique: his ability to stage scenes from everyday life in a socio-realist manner that also addresses universal concerns.

The cover is reproduced courtesy of the artist and Soemo Fine Arts, 66 Xiaopunanjie, Songzhuang, Beijing (www.soemo-fine-arts.com / info@soemo-fine-arts.com)

ANNUAL MINISTERIAL BRIEFING ON CHINA'S DEVELOPMENT & FOREIGN INVESTMENT POLICIES

Every year Chris Devonshire-Ellis, the Senior Partner of the business and tax consultancy Dezan Shira & Associates, and publisher of China Briefing, is invited to spend a few days with various Ministers for an update on reforms and policy changes that affect foreign direct investment. One of the few foreign businessmen to be granted such privileges, these are then presented in an annual special issue of China Briefing. This report details his findings from his meeting this year, which took place just after the annual National People's Congress. We also highlight further information concerning some of the regulatory changes that have recently been introduced that affect income tax, property, and labor laws.

Executive Summary

From the macro-economic position, China's 11th Five Year Plan got off to a good start in 2006, against a positive background of high growth and low inflation that is expected to continue for some time. However, against this, the Chinese government is concerned about the imbalances in the economy, and in particular the huge trade surplus, which hit US$177.5 billion in 2006 and was US$39.6 billion in the first two months of this year. That is a 225 percent increase on last year's figures. They are also concerned about the continuing expansion of China's foreign currency reserves, which are now in excess of US$1 trillion and saw an increase of US$200 billion in 2006 alone.

A study led by the Ministry of Commerce is underway to explore methods to reduce the trade gap surplus by promoting imports. In the meantime, the Ministry of Finance, the State Administration of Tax and the General Administration of Customs are formulating new policies to further enhance this in respect of their own areas of responsibility. In fact I have never seen the government so focused on these issues, and the various ministries so well coordinated in my years of meeting with them. These may, I suspect, lead to future announcements of policies intended to increase China's imports, some of which will be domestically driven. Indeed, getting consumers in China's massive rural areas to buy imported products is a key area – 70 percent of China's population is in these regions. If China does not succeed in dealing with this issue then it will walk into serious conflicts over trade imbalances and RMB appreciation, leading to greater diplomatic, political and trade pressures. The U.S. Congress for example is already planning new trade sanctions against the PRC.

Liao Xiaoqi, Vice Minister, MOC

Sustainability of the Economy, Environment & Energy

After meeting with the Central Financial Work Leading Group (CFWLG) of the Bureau of Economic Operations and the National Development & Reform Commission (NDRC) it is apparent that the Chinese government is determined to implement a sound financial model to pursue sustainable development. Under the 11th Five Year Plan, China specifically aims to reduce energy consumption per unit of GDP by 4 percent per annum, or a 20 percent reduction over five years. (see also *China Briefing*, Page 7, April 2006 issue at archives section on website at **www.china-briefing.com**). However, China's strong growth during 2006 meant it failed to hit this target. Energy consumption though began to fall in the third quarter, but overall achieving a 1.23 percent reduction in the year over 2005.

According to the NDRC, China will increase efforts to better monitor its environmental performance this year, with more effective environmental legislation in the pipeline. The implementation of these policies will be more effectively policed. Departments such as the NDRC are studying new policies to cope with the more stringent demands on international communities on environmental protection and greenhouse gas emissions now the framework exists following the Kyoto Treaty. Indeed, the ministries concerned were all active in this area, again, with a unified approach. One of the officials at the Ministry of Commerce even setting a specific example; how in 2006 China exported 40 million tons of steel (China produced as much steel as the worlds top 15 global producers combined that year). The energy required for steel production in China was equivalent to 30 million tons of standard coal. If China had not processed and manufactured this amount of steel for export, and did not earn the income, then the energy consumption per unit of GDP last year would have dropped a further 1.26 percent. That would have provided a better attempt at reaching the stated environmental goals. The impression given now is that more and more senior officials in China are placing environmental protection ahead of GDP growth.

Processing Trade Policies

Regarding trade policies, the Ministry of Commerce, the NDRC, Ministry of Finance, State Administration of Tax and the General Administration of Customs were all clear on this point: Adjustments to processing trade policies are a matter of established policy. Following last years scrapping of the export tax rebates for resource and energy inefficient, and pollution intensive products, the current restrictive policies governing processing trade would be tightened instead of relaxed. A common theme was that China could no longer export its profits overseas while retaining the pollution within its borders.

In view of the potential impact of adjustments to processing trade, the Ministries and Commissions all advocated a cautious approach, while conceding that some grace periods would be permitted, especially for Hong Kong investors in South China, who need time to effectively move their investments elsewhere. Further details of these are to be released by the Ministry of Commerce in due course.

Departments such as the General Administration of Customs are also implementing measures such as "e-ports" to help processing trade businesses better conduct their processing transfer operations, enhancing their asset chains and boosting their operations in the Mainland. However, it was clear that even more stringent restrictions would be imposed in the future.

Hong Kong and Shanghai as Financial Centers

At meetings with the CFWLG, NDRC, China Banking Regulatory Commission (CBRC) and the China Securities Regulatory Commission (CSRC), all pledged continuing support for Hong Kong as China's international financing hub. It was recognized that no mainland city would easily be able to replace or compete with Hong Kong's position and that it would be protected. Indeed, the CBRC lavished praise on the Hong Kong Stock Market for its substantial contributions to the reforms and listings of the Bank of China, Industrial & Commercial Bank of China, and the China Construction Bank. It was recognized that this is one area of economic integration between Hong Kong and the mainland that can be further strengthened. The CSRC is also working on plans for closer cooperation between the Chinese and Hong Kong financial securities markets for example, by encouraging concurrent listings of A and H shares. A share companies will also be encouraged to list on the H share

Liu Min Kan, Chairman, CBRC

bourse. In this manner a leading official explained the relationship between Hong Kong and Shanghai – the latter for mainland companies raising money from mainland Chinese investors, and the former for the international markets, with dual placements for larger companies with both domestic and international markets.

Conclusion

Overall, a shift in the mind set of the Chinese government has occurred. They are beginning to appreciate a deeper understanding of what sound development and sustainable development models should be, and this is quickly leading to new policies, and higher levels of inter-ministerial cooperation. International investors should consider sustainable development of added value services with low energy consumption models to best take advantage of this new political and economic environment within the PRC.

THE MINISTRIES

Ministry of Finance

Wang Xiao Hua, Vice Director-General, Tax Policy, MOF

Q: *How has China's economy been developing?*

A: During 2006, GDP grew very quickly. As long as the economy grows faster than tax growth we can sustain economic development. We can adjust tax income to manage the economy. In terms of goals, we will be providing tax incentives to further spread wealth amongst the nation. For example, with the Go Inland Campaign (see China Briefing, November 2006 issue) investment into these regions will be enhanced, and may include future tax incentives for foreign investors. This also applies to the Western regions. Key projects, such as the Qinghai-Tibet Railway will continue to be supported, as will key road, rail and air transport routes. Environmental protection is now a cornerstone policy, and we also need to open up the rural areas. This means getting water management systems in place, and getting education, healthcare, electricity and clean water into the rural areas.

Concerning trade imbalances, any reduction in this will be tax based rather than investment based. However we are looking at establishing a Government Investment Company who would look at addressing this issue and be partially responsible for actioning the trade imbalance issues we face.

Q: *Is the ministry planning to carry out tax reform on fuels? Given that fuel taxes might have increased prices of petrol and diesel, what kinds of factors will the ministry consider before carrying out reform?*

A: Oil Prices are increasing globally as we all know. Taxes will be reformed, and will also include infrastructure based taxes such as highway tolls. Reforms will be designed to encourage the efficient use of energy commodities, and implementation by the State can be expected shortly.

Q: *Are there plans for the ministry to reform the resources tax system and to launch a property tax? How will the ministry work out a modest tax reform?*

A: China's property prices are not a reflection of the true market value, they are currently based on supply and demand; accordingly tax reform is needed. Reforms will be market driven and are expected to see a reduction in taxes, with implementation and standardization expected this year. We are waiting for the State Council's approval on this matter.

Q: *As the Property Law, which signifies a protection of property ownership, has finally been passed by the National People's Congress, many believe that this now forms the basis for the formation of a new property tax. How will the authority be able to manage the number of possible new taxes launched after the implementation of the property law with the existing tax for acquisition of land trade?*

A: Different taxes apply for foreign direct invested property and the domestic market. We want to standardize these two elements. The current valuation processes for property also need reform. We also need to cool down the economy by making adjustments to taxes. Unification between foreign and domestic property law will take place. Concerning valuations, property will be valued and taxes applied; we already have a pilot scheme operating on the principle in six provinces. We are evaluating this system and it is likely to be implemented in 2008 or 2009.

We do agree with the policy of gradually implementing new laws and changes to tax. Some property investments are overheated and change hands many times due to speculators; future property taxes may include transaction based taxes based on change of ownership.

Q: *Will the Chinese government issue convertible RMB bonds in Hong Kong?*

A: This year is the tenth anniversary for the people of Hong Kong to return to the Motherland. We may plan a gift. But I cannot be specific about this.

The State Administration of Tax

Wang Li, Vice-Commissioner, SAT

Q: *Under the unified income tax system, can foreign investors still enjoy a 15 percent rate in the Special Economic Zones and Development Zones after the transitional period?*

A: Foreign investors qualifying as hi-tech or specific encouraged industries may still establish themselves in these specific parks meant for such investments at 15 percent. Otherwise for other zones the 15 percent rate will disappear by 2013. We may consider, at State level approval, additional tax breaks and incentives for particular preferred industries elsewhere if we deem it appropriate. We are also continuing tax incentives for hi-tech and SMEs.

General Administration of Customs

Q: *Official data showed that the China trade surplus jumped almost 67 percent to US$15.88 billion in January this year. Some believe tax evasion is one of the reasons leading to the trade imbalances. Has the authority carried out any measures to address this problem?*

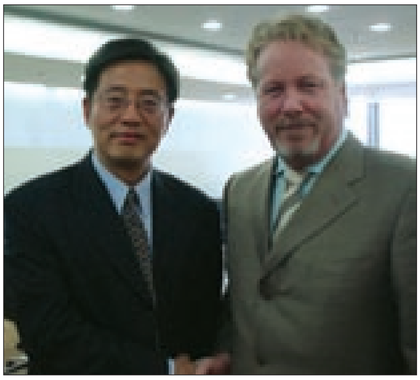
Sun Songpu, Vice Minister, Customs

A: We have invested in and are implementing a national computerized Information Management Tracking System – staff are being trained in this right now to discourage re-exports. All major cities are interlinked and it is already up and running in the Pearl River and Yangtze River Deltas. We are also recruiting more personnel. We have also had to switch to a WTO based standard and this is not yet uniform across the PRC, leading to customs classifying some products in the wrong category. If we find companies do this deliberately then they will be blacklisted, although we can make mistakes too. It is an ongoing matter of our own development and we are making progress.

Q: *In order to suppress the existing trade surplus, which was mainly fuelled by the processing trade, the Central government announced a series of processing trade policies to expand the prohibited categories of processing trade. Given that more changes could be implemented under the principle of 'dynamic adjustment', have any measures been planned to alleviate the impacts so the new policies can be implemented smoothly?*

A: We have over 1,000 categories listed under the prohibited categories and this will expand. High polluting, energy inefficient, and low tax paying (inefficient) businesses will be targeted via tax reforms to enable us to upgrade our industry standards. We are still assessing the viability of industries involved in furniture, paper and water-quality affecting products. Industries consuming inefficient amounts of resources, or those who pollute, will be discouraged. A new catalogue for the processing trade industry sector will soon be published and will identify the industries concerned and the measures to be taken. Affected businesses will be given time to adjust.

The China Securities & Regulatory Commission



Tu Guangshao, Vice Chairman, CSRC

***Q:** How are Hong Kong and China Cooperating?*

A: We are very pleased with Hong Kong's performance, and will be protecting its unique position as a gateway for international finance. Last year, over 40 mainland companies listed in both Hong Kong and in Shanghai or Shenzhen, and Hong Kong is becoming more interactive with the mainland in its new role serving China's international financial requirements. The cooperation is working very well and we would like to expand on this.

***Q:** Are there to be any further restrictions on the listing of Chinese domestic enterprises?*

A: There are no further restrictions to be put in place as long as our Mainland companies meet Hong Kong's listing requirements. Hong Kong is doing a good job and we do not need to get involved. Its economic strength is excellent and market demand is still there. Hong Kong will continue as the hub for Chinese companies wanting to reach international investors, and to improve the management and international capabilities of Chinese domestic businesses. Shanghai and Shenzhen listings will remain as they are for the domestic market, although of course some of these companies can also grow later to list in Hong Kong when they are mature and ready enough. Shanghai and Shenzhen to some extent are our nursery bourses, focusing on development, while Hong Kong remains as an internationally mature market for more established businesses with an international outlook. The roles are and will remain in this manner.

***Q:** Where are we with the ongoing development of QDII? (Qualified Domestic International Investors)*

A: We are still discussing this with the Hong Kong authorities and working out how we can get wealthy Mainland Chinese qualified and regulated access to the international markets, with a format to allow them investment in both the Mainland domestic and Hong Kong financial markets. We need to establish cross border settlement systems and this need to be agreed upon, set up, and implemented. Both platforms in Hong Kong and China will need to be interactive and settlement companies being able to provide cross-border services. The researching and testing of financial products also needs to be interactive.

***Q:** How do you see the future role of Hong Kong compared to Shanghai?*

A: We think one international financial center is enough, and we have one in Hong Kong. The United States, a far bigger market than ours, tried two centers with New York and San Francisco, and people still preferred New York. Hong Kong will continue its role as China's primary international finance center and Shanghai and Shenzhen will continue their roles as domestic financial centers. We see no need or reason to change this system.

National Reform & Development Commission

***Q:** How is the Government dealing with the Processing Trade issue and the trade imbalance?*

A: The Government does not encourage the export of high-energy consuming, high-polluting and low-value products with no or low added value. Accordingly, via the tax mechanisms at out disposal we will discourage trade in these products. We need to encourage in the same manner energy efficient industries, with a green attitude, that can add to our development and economic growth. This also extends to industries that can help us get there in terms of better managing our resources, including water management, and oil, gas and coal technologies.

We are also taking domestic steps as well – for example all coal / steel manufacturing or processing plants or mines producing less than 1 million tons a year will be closed down.

***Q:** What is your position over the recent income tax unification and its impact on future foreign direct investment?*

A: FDI comes to China because of globalization, not because of our tax rates. We must encourage domestic demand for goods and services and not just rely on an export driven model. This signifies a change in our economic policy and will continue to be reviewed and enhanced.

***Q:** How do you view the position of Hong Kong as a financial center compared to Shanghai?*

A: The Central Government will maintain its position in using Hong Kong's expertise and infrastructure as our open door to international finance. Shanghai will concentrate on the domestic markets, while our banks of course are all headquartered in Beijing. In fact, we have a new Wall Street in Beijing now where all our banks are concentrated.

***Q:** How can China improve its logistics services?*

A: Shenzhen actually is a very competitive logistics centre and is more competitive than Hong Kong. However we still face air space issues, and we are working on this. We recognize that China faces back office operation problems, mainly due to linguistic, and experience difficulties. We are looking at the regulatory environment also to try and open up this sector more to develop this type of service in China.

***Q:** How can China encourage domestic consumerism?*

A: This is a very tough issue. We need to get wealth into the rural areas, and China's demographics are changing too. We need to enlarge the consumer base in rural areas, and we are looking at this issue – issuance of credit cards, bank loans for example to kick start the Chinese economy. It's a serious and complicated matter we are still evaluating.

CHINA'S UNIFIED CORPORATE INCOME TAX

An update on the specifics & the un-resolved Issues

On March 16, 2007 Chinese lawmakers passed the much talked about corporate income tax law, unifying the tax rates for foreign and domestic enterprises. The new law, which passed 2,826 votes for and 37 against with 22 abstentions, will bring China's tax laws more in line with international standards. It has unified the two existing tax codes; one for domestic enterprises, the other for foreign invested enterprises (FIEs), into one and represents a fundamental change in China's tax policy. Many of the tax incentives and tax holidays that existed in the old code for foreign investors have been changed or eliminated.

Set to take effect January 1, 2008, the Enterprise Income Tax Law of the People's Republic of China contains general provisions on the law as well as chapters on what constitutes taxable income, taxes payable, tax incentives, withholding tax at the source, special tax adjustments, administration of the levy and collection of taxes, as well as some supplementary provisions. As is common in China, the details of those provisions, as well as their interpretation and application will be left to further regulations and supplementary circulars. The law has been written, but it remains to be seen how it is to be fully implemented. Some clarifications concerning qualifying for preferential treatment and deadlines for implementation have still to be issued.

Tax unification

The income tax rate for all companies in China, both foreign and domestic, will be 25 percent. This means that most foreign invested companies in China will see their taxes increase, while most domestic enterprises will pay less to the tax authority. Both international and domestic companies will now compete based on only quality and service but not preferential income tax rate. Domestic companies in the past have been notorious for under-reporting their profits and the government will have to properly administer tax collection from domestic companies under the new system lest they be seen as deliberately collecting less money from domestic businesses to help their competitiveness. This could be used as a stick to beat China with concerning trade imbalances as being effectively a 'tax subsidy' for Chinese businesses should the collection base remain ineffective.

While the new unified rate of 25% is an increase from the preferential tax rates of the past for FIEs, the change will likely have more of an affect on small to medium enterprises at the low end that, being typically undercapitalized, may look elsewhere to invest. The new rate is also designed, in some part, to discourage foreign investors of such types to invest here on the grounds that they are not tax productive in any event. Additionally, in order to deal with the massive trade imbalance China possesses, and in particular with the US, an increase in tax affects a large portion of the process manufacturing trade that is responsible for much of this. China intends to further clamp down on such activities, and a migration of this type of business may take place, probably to India. Additionally, industries that are inefficient in terms of energy use, polluting, not adding value or are tax inefficient will all feel the impact of this measure.

The larger, more established enterprises have seen this change coming and will have prepared for it. As the law has changed the incentives from nationality-based to industry-based, enterprises that are involved in the high/new technology sectors, be they foreign or domestic, will still enjoy some preferential policies.

It should also be pointed out that the 25% tax rate is still a substantial discount on Europe, the US, and many other Asian countries. And while many of the tax incentives that FIEs used to enjoy have been eliminated, the new code does still contain incentives for specific sectors and industries, as well as geographical areas that the government is keen to develop. In means China is using its tax base mechanisms to drive the country ahead and further up the added value chain as part of its national development policy.

Preferential tax rates

Preferential tax and land policies or "policies superior to national treatment" have always attracted foreign investment, dating back to the 1970s when Beijing began its opening-up policies, and several of these still remain, albeit in modified form, in the new tax law.

These preferential rates are being used by the Chinese government as a way to promote foreign investment in sectors that it wants developed. This includes agriculture, forestry, animal husbandry, fisheries and infrastructure construction. Small-scale, low profit enterprises that meet prescribed conditions will also have a reduced tax rate of 20 percent, although the qualification of this has not yet been determined by the State Council.

The government has been growing concerned about environmental issues, developing its own tech industry, and energy conservation and the new law reflects these concerns. Preferential tax treatment for enterprises investing in environmental protection has been kept and a tax rate of 15 percent applies for high and new technology enterprises to which the state provides key support. Key areas are the promotion of energy efficiency, environmentally friendly technologies, and water management. All these sectors are encouraged, both in terms of the provision of the technology but also in industrial operations.

Since the late nineties China has been seeking to push investment and capital into its vast underdeveloped western regions. Through programs like 1999's

Go West campaign and 2004's Go Inland campaign, China has used massive tax incentives to encourage foreign direct investment (FDI) in these regions. While not mentioning either of these campaigns specifically, the new law does say that the state will offer "tax incentives to industries and projects that are eligible for key support from the sate or whose development is encouraged by the state." Therefore, it is highly likely that the current preferential tax policies for development in these encouraged areas will continue to be implemented, and new incentives identified.

Additionally, a transitional preferential tax treatment shall apply for newly established hi-tech enterprises receiving priority support from the state, located in special economic zones (SEZs) and involved in technology transfer. The details for these tax exceptions are vaguely worded and it remains to be seen how and when the new policies will be put in place. Again, the State Council has yet to issue directives on the qualifications required.

The preferential tax treatments currently enjoyed by high-tech enterprises in these SEZs and the Pudong New Area of Shanghai still apply if a business is recognized as a "hi-tech" entity.

Transitional tax period in SEZs & Free Trade Zones

FIEs in more mainstream sectors like manufacturing or labor-intensive production will have to change some of their practices to compete in the new market, but as we said before, most have seen this coming. The Chinese government doesn't expect these zones to change immediately from January 1, 2008, and has therefore built in a five year transitional period over which companies currently enjoying reduced tax treatment will see their rates gradually increase to 25%.

It must be pointed out that this transitional period only applies to companies that were established before the promulgation of the new tax law. Also, the transitional period will begin on January 1, 2008 regardless of if an enterprise has not made a profit. This means that by 2013, the previous policy of tax holidays for FIEs will have been eliminated. Although this has yet to be confirmed, it is likely that rates will be increased in such zones by 2% per annum over the next five years.

Conclusion

The Enterprise Income Tax will bring fundamental changes to most FIEs in China. Companies will have to re-evaluate their tax profile and this could lead possibly to an increase in transfer pricing issues. However, when used as a legitimate structure supported by pertinent documentation, this will not be problematic. The government will be looking out for transfer pricing mechanisms used to deliberately defraud the tax bureau.

As we said earlier, most large international corporations will have started planning for this long ago and so the change will not affect their long term plans. GE (General Electric) China for example, announced that it will invest US$50 million in its Shanghai-based technology centre for products serving environmental protection, including more efficient airplane engines and wind power generators, seawater desalination technology and energy-saving bulbs.

By creating tax parity between state owned enterprises, local private enterprises, and international businesses, Beijing will be under pressure to properly administer tax collection from domestic companies, otherwise they will find it used as a weapon against them over currency and trade imbalance issues. The manner in which the new tax law is implemented will be a key driver in China's bi-lateral relations with other countries in years to come. China's tax collection problems have long stemmed from cronyism between tax officials and local businesses, and the government will have to continue to address this as it moves forward with the new tax law.

The tax unification also shows China's intent to move up the value chain, and shows a more measured and considered approach to the type of foreign investment it now wishes to attract. The policy of adjustments will continue as China develops further and wishes to manipulate its domestic companies and consumption to better obtain a more balanced economy.

Labor Contract Law – legal update

[By Richard Hoffmann, Senior Associate, Dezan Shira & Associates Beijing office]

After receiving overwhelming feedback from our readers regarding our first article on the new labor contract law in the Beijing Update of the March *China Briefing*, we decided to brief you again on this hot topic.

The Standing Committee of the 10th National People's Congress (NPC) will read the controversial draft labor contract law for the third time at the end of April, meaning they will discuss the third draft of the law. The Legislation Law stipulates that a draft law has to go through three readings before it can be forwarded for voting. Based on our discussion with the authorities, we doubt that the third draft will have any major changes in comparison to the Second Draft, so we have decided to inform you again about the rules and regulations.

What does the current Second Draft say?

Probationary period

The maximum probation period is based on the term of the contract, thus:

- one month, if contract term is less than one year
- two months, if contract term is less than three years
- six months, if contract term is more than three years

The Second Draft requires employers to pay their employees at least 80 percent of their contractual salaries during the probationary period.

It is expected that the penalties for violating these rules will increase and that termination of contract during the probationary period without notice or severance will be more difficult. The employer will have to prove that the employer doesn't fulfill the recruitment conditions set out in the employment contract.

What does this mean for foreign investors?

Less flexibility: Employers have to be more careful when hiring new staff. Even termination during the probationary period requires sufficient evidence.

Fixed term contracts

The Second Draft only allows two fixed term contracts. Any further contracts must be an open term contracts. After expiration the employer has to agree on an open term contract with the employee.

An employer must pay severance to any employee whose fixed-term contract is not renewed to the amount of one month of salary for each year served, unless the employee rejects a new contract on equal or improved terms.

What does this mean for foreign investors?

Less flexibility and more costs: The employers should consider carefully the length of the fixed term contract and assess the ability of the employee carefully.

Mass-layoffs

A change in the objective circumstances on which the employment contract was concluded is per definition a basis for a mass-layoff. In addition a mass-layoff is defined in the Second Draft as the laying off of 20 or more employees or 10 percent of total staff. The employer must explain the circumstances of the layoff to the trade union or to all its employees, giving 30 days advance warning. The Second Draft emphasize these may apply only for senior managers, senior technicians and other people who have knowledge of the trade secrets of the employer.

What does this mean for foreign investors?

A sophisticated drafted contract will help to create mass-layoffs. In employment contracts, employees and employers could agree that certain business circumstances are essential and that any change in these circumstances could be grounds for a mass-layoff.

Non Compete Clauses

As we have been often asked from our readers, there is no specific amount of compensation mentioned in the Second Draft and there is no provision about maximum amount of penalty. This is different from the First Draft which stated that the compensation for the employee should not be less than the annual wages and the violation penalty should not be more than three times the compensation paid by the employer for their competition restriction.

What does this mean for foreign investors?

Based from our discussion with the authorities we guess that we might see changes in the Third Draft regarding this issue. We emphasize that non-compete clauses in contracts are drafted carefully. Unreasonable figures of penalty are counterproductive. The best chance for enforcing penalties will be reasonable amounts and clear wording.

Making of Company Rules

The Second Draft modifies the procedure of company rules that have a direct bearing on the immediate interest of employees (work hours, rest, leave, work safety, compensation etc.). The First Draft codified that an approval by the labor union, workers' congress, or by workers' representative assembly or equal negotiation is necessary before implementation. However, the Second Draft only requires a consultation with the labor union, workers' congress, or by workers' representative assembly or equal negotiation.

But who has the right to change the provisions after it is implemented and what is the procedure?

- If the labor union or an employee is of the opinion that the rule or regulation is inappropriate. The rule or regulation should than be improved after consultation.
- The Labor Bureau has the right to order an employer to change company rules that violate laws and administrative statues

What does this mean for foreign investors?

Choose your wording carefully; be cordial if you meet with the labor union, workers' congress, or by workers' representative assembly or equal negotiation. You don't want to loose time in ongoing discussions about what is contained in your rules and regulations.

Interpretation of contract

Under the Second Draft, employees can insist on a written contract within one month of starting work, and an employer who fails to provide such a contract after one month will be forced to pay the employee twice their salary. Even if this sounds disadvantageous for the employer, it isn't if you compare the situation with the First Draft. Previously, an automatic open term contract was the penalty for failure by the employer to provide a written contract.

The reason for such a provision is can be found in a study the NPC did which revealed that four in five private enterprises in China have not signed job contracts with their employees!

What does this mean for foreign investors?

Prepare your contracts in advance and let your employees sign them at the beginning of the contract term. It is not worth waiting.

And what does this all mean for the future?

Overall, it is somehow dispiriting for employers. Labor costs may increase (severance), there is less flexibility (rules, regulation, short term contracts) and the employee will be able to sue employers directly for unpaid wages – currently employees must first seek relief from labor arbitration tribunals.

Unresolved Issues

Some of the issues that have been long discussed are not addressed by the Second Draft. In particular, there is no difference between workers who need special protection and senior management staff that probably need far less. We miss regulations about enforcement issues and or how employees may seek for justice.

Even the current labor standards are more generous than standards in other developed countries. The problem is that these current standards are largely ignored. Employers and authorities are not able or willing to enforce them and this is the reason for unfair treatment of millions of employees.

Always keep in mind if you compare the rules and regulations of the Second Draft with the labor law situation in your home country, you may still have more flexibility here in China. Treat your staff well, hope that they do well; but be prepared for the worst case!

The New Property Law: A milestone on the path toward a market economy?

[By Richard Hoffmann, Senior Associate, Dezan Shira & Associates Beijing office]

On the March 16, 2007 the National People's Congress (NPC) adopted the new Property Law for the People's Republic of China. The 247-article law, which is due to come into effect as of Oct. 1, 2007, stipulates that "the property of the state, the collective, the individual and other obligees is protected by law, and no units or individuals may infringe upon it." This is the first time that equal protection to state and private properties has been enshrined in a Chinese law, which analysts say marks a significant step in the country's efforts to further economic reforms and boost social harmony.

But what does this all mean to the foreign investor? Is the new law a milestone on the path toward a market economy? Here we will list down the main important provisions that could be of interest for the foreign investor:

Ownership of the PRC

China will keep its socialist economic ownership system. The owner has the right to possess, dispose of and obtain profit from their real or movable property.

3-types of property

China distinguishes and protects three types of property equally - state, collective and private property. Any infringement trough units or individuals are strictly prohibited and will be punished.

State owned property: There are certain properties that are stipulated to be owned from the state. These are for example mineral resources, waters, see areas and the urban lands. In addition, rural land and land on the outskirts of cities are owned by the state. Further all natural resources – mountains, forests, grassland, beaches and unclaimed land and as well as wild animals and plants – if not collectively owned, are state owned. No foreign investor will enjoy property rights here.

Collectively owned property: Collectively owned property refers to buildings, production devices, water power facilities and education, science, culture facilities in regards to education, science, culture, health.

Privately owned property: The law, conforming to constitutional principles, further consolidates protection for private property – movable and real property. There a provisions on ownership of salaries, condominiums and parking lots. Specified is the relationship between property management service providers and home-owners.

Land expropriation

The new law stipulates protections for farmers against expropriation of collectively-owned land. Compensation has to be paid in order to guarantee a normal life and secure of their interests.

Establishment, Transfer, Modification and Lapse of Ownership

In general, the establishment, modification, transfer and lapse of the right in real estate have to be registered, otherwise it is not effective. Registration has to be done by the registration department of the place where the property is located. There will be a uniformed recording system at the national level.

Registration could take a long time. To ensure the realization of property rights the new law allows one to register a pre-notice registration with the relevant registration department. After the pre-notice registration, the disposal of such real property is not effective without the consensus of the owner.

Transforming into construction land

The right to the use of construction land entitles the owner to build facilities and to possess, utilize, and obtain profit from State-owned land. To obtain the use of construction land is complicated as the transfer of property rights is highly restricted. The rights have to be assigned by an auction or invitation to bid and the contract between the parties must include the following terms:

a) names and domicile of the parties
b) location and size of the land
c) size and structure of the buildings and accessory facilities
d) Land purpose
e) Terms of use
f) Amount and payment conditions
g) Resolution provisions in case of a conflict.

The owner of the above mentioned rights has the right to use the land for transfer, exchange, capital contribution and mortgage.

Summary

The detailed provisions on private property in the PRC are important for security of the ownership and will be a major incentive for foreign investors to come to China. Be aware that additionally Circular 171 (mentioned in *China Briefing* 10/2006 **www.china-briefing.com**) is still applicable and it is difficult for foreign investors to purchase real estate. There are some issues that need to be clarified – especially in the case of a dispute. But with the promulgation of the new law, there are less risks and pitfalls for foreign investors, the Chinese government is on the right track!

For requests regarding the property law, assistance in structuring your business and contract drafting, please contact Richard Hoffmann in the Beijing office of Dezan Shira & Associates, at **richard.hoffmann@dezshira.com**, tel. 010-6510 2288.