

China Tax & Investment News



China Issues PRC Corporate Income Tax Law Implementation Rule

Introduction

After many years of internal study, public consultation and drafting, the People's Congress (the country's highest legislative body) finally approved and announced the new Corporate Income Tax Law (the "CITL") on March 16, 2007, which will become effective January 1, 2008. Like many other pieces of legislation in China, the new CITL only laid down the overall guiding principles in a broad-brushed manner, leaving finer details to be elaborated by the State Council.

The CIT Law Implementation Regulations (the "CITLIR") which contains further details on definition of terms, scope of charge, and application to specific situations has just been issued by the State Council yesterday.

During the drafting stage of the CITLIR, a lot of hearsays on bits and pieces of possible provisions had been circulated within the business circle. We have in our previous edition of the China Tax and Investment News summarized the key provisions that were believed to possibly appear in the CITLIR. However, it now turns out that the final CITLIR has left out a lot of detailed provisions that were in the earlier drafts. We understand the authorities have chosen to subsequently issue a series of circulars as supplements instead of including them all in the CITLIR. Hence a lot of hearsays remain hearsays. We will have to rely on further interpretation circulars to be announced by the State Administration of Taxation to clear up the sky.

We have in this issue of the China Tax and Investment News outlined the more important known provisions in the CITLIR for your easy reference. Please refer to the tables that accompanied this News which show, together with our remarks, how the CITLIR clarifies the CITL so far.

Recommended Actions

As pointed out above, despite the release of the CITLIR, there are still a lot of uncertainties in how the new CITL will be implemented. Please study and understand the information available in the market now, consult professional advisors and the Chinese tax authorities for clarifications in case of doubt, and stay tuned for further developments.

KEY FEATURES OF THE NEW CIT LAW IMPLEMENTATION RULES

(1) Clarifications on Chapter 1 of the New CITL (i.e., General Provisions)

<u>CITL(*)</u>	<u>CITLIR (#)</u>	<u>Remarks</u>
<p><i>Articles 2 and 3</i></p> <p>A company incorporated outside China but having effective management in China will be considered a tax resident and subject to tax in China on worldwide income</p>	<p><i>Article 4</i></p> <p>Defines effective management as the “overall management and control of the production, business, employees, finance and assets of a company”.</p>	<p><i>With such a general definition, the conclusion on tax residency would likely be determined by the tax authorities basing on the facts of each case. It is advisable for foreign companies to err on the side of caution and refrain from putting business functions inside China and thereby risk being caught by the Chinese tax net.</i></p>
<p><i>Article 3</i></p> <p>A non- resident company having a permanent establishment (“PE”) in China should be subject to tax in China on income arising in China, as well as income arising outside of China which is actually connected to the PE.</p>	<p><i>Article 5</i></p> <p>Defines PE in a way very similar to the old one, and in line with international practice.</p>	<p><i>The proposed definition of a business agent having a general authority to carry out business activities for the principal other than purchases and sales constituting a PE that appeared in earlier drafts has now been dropped.</i></p>

* Corporate Income Tax Law enacted on March 16, 2007

Corporate Income Tax Law Implementation Regulations issued December 6, 2007

(2) Clarifications on Chapter 2 of the New CITL (i.e., Taxable Income)

<u>CITL</u>	<u>CITLIR</u>	<u>Remarks</u>
<p><i>Article 6</i></p> <p>Defines income to include, among other things, dividends from equity investment, interest, rental, royalties and donations.</p>	<p><i>Articles 17 to 21</i></p> <p>Dividends should be recognized as income at the time the investee company “declares” a profits distribution.</p> <p>Interest, rental and royalties should be recognized as income at the time when payment is due according to contract.</p> <p>Donations should be recognized as income at the time of actual receipt.</p>	
<p><i>Article 8</i></p> <p>“Reasonable” expenses “related” to the production of income can be deducted in arriving at the taxable income of a company.</p>	<p><i>Article 27</i></p> <ul style="list-style-type: none"> • “reasonable expenses” means necessary and normal expenses in line with ordinary business operations; and • “related expenses” should be construed as expenses directly connected to the production of income. 	<p><i>The more restrictive deduction criteria as reflected by the usage of terms like “necessary”, “normal”, “ordinary” and “directly” may add ammunition to the tax officers in disallowing expense deduction.</i></p>

<u>CITL</u>	<u>CITLIR</u>	<u>Remarks</u>
	<p><i>Article 34</i></p> <p>“Reasonable wages” and salaries actually incurred are tax deductible.</p>	<p><i>The emphasis on reasonableness tends to indicate that it is the tax authority’s wish to reserve a right to adjust wage and salary deductions when considered necessary. Such right was in the old domestic CITL.</i></p>
	<p><i>Article 36</i></p> <p>Premiums paid on commercial insurance policies for investors and employees are not tax deductible unless related to occupational safety or approved by Ministry of Finance (“MoF”) or State Administration of Taxation (“SAT”).</p>	<p><i>We will have to wait for further details from MoF and SAT on what will appear in the approved list of policies.</i></p>
	<p><i>Article 38</i></p> <p>Interest paid on bank loans can be tax deductible. However, those paid to non-financial- institution lenders may only be deductible up to the normal interest rate offered by commercial banks.</p>	
	<p><i>Article 40</i></p> <p>Employee welfare expenses are deductible subject to a cap at 14% of the total salaries and wages.</p>	

<u>CITL</u>	<u>CITLIR</u>	<u>Remarks</u>
	<p>Article 42</p> <p>Employee education expenses are deductible subject to an annual cap at 2.5% of the total salaries and wages. The excess can be carried forward for deduction in the following tax years.</p>	
	<p>Article 43</p> <p>Only 60% of entertainment expenses actually incurred will be tax deductible subject to a cap at 0.5% of annual turnover.</p>	<p><i>This is a significant departure from the provisions of old laws (for both domestic companies and FIEs) where full deductibility was possible within a cap.</i></p>
	<p>Article 44</p> <p>Advertising and promotion expenses actually incurred in a year can be tax deductible up to 15% of the turnover for that year. The non-deductible amount for a year can be carried forward for tax deduction in future years.</p>	<p><i>This is a significant departure from the provisions of old laws (for both domestic companies and FIEs). Previously, FIEs are not subject to any cap. For domestic companies, advertising expenses were capped at different percentages of annual turnover depending on industry; and promotion expenses were capped at 0.5% of annual turnover without any carry forward provision.</i></p>

<u>CITL</u>	<u>CITLIR</u>	<u>Remarks</u>
	<p>Article 49</p> <p>Inter-company management fees, intra-company rental charges and royalties payments among business units, and intra-company interests among business units of non-financial-institutions cannot be tax deductible.</p>	<p><i>Despite a different earlier draft, we are now back to the old situation that “management fees” are not tax deductible. We understand the SAT interprets “management fees” to mean a pure reallocation of overhead expenses without specific benefit received by the payer of the fees. In situations where there are specific benefits and a service fee should be charged, our advice is to avoid using the term “management fees” but instead describe the specific service in an intercompany contract. We recommend documenting the evidence of benefits received.</i></p>
<p>Article 9</p> <p>Restricts deductibility of donation to 12% of annual profits</p>	<p>Article 53</p> <p>The term “annual profits” means the accounting profits for the year according to Chinese GAAP.</p>	
<p>Article 10</p> <p>Disallows sponsorship expenses for tax deduction.</p>	<p>Article 54</p> <p>Defines sponsorship as the sponsorship not in the nature of advertisement and which is not related to the production and operation of business.</p>	<p><i>As no further details are available, the matter again appears to be left to the discretion of tax officers. To remove such uncertainty, the traditional wisdom has been to appoint an advertising agency to handle these promotional activities and ensure a tax deduction.</i></p>

<u>CITL</u>	<u>CITLIR</u>	<u>Remarks</u>
	<p>Article 60</p> <p>Provides that transportation equipment other than aircrafts, trains and vessels should be depreciated over not less than 4 years; For electronic equipment, not less than 3 years.</p>	<p><i>The depreciation period was 5 years in the old laws.</i></p>
<p>Article 12</p> <p>Disallows internally generated goodwill for tax deduction.</p>	<p>Article 67</p> <p>Provides that purchased goodwill can only be deductible at the time when the company transfers its entire business or liquidates.</p>	<p><i>This potentially may have major tax implications in a merger and acquisition situation.</i></p>
<p>Article 13</p> <p>Provides for tax deductible amortization of long term expenses including :</p> <ol style="list-style-type: none"> 1. alteration of fully depreciated fixed assets; 2. leasehold improvements; 3. major repairs on fixed assets; and 4. other long term expenses. 	<p>Article 70</p> <p>Lists the minimum amortization periods as follows:</p> <ol style="list-style-type: none"> 1. alteration of fully depreciated fixed assets : estimated usable period; 2. leasehold improvements : remaining period of the lease; 3. major repairs on fixed assets : estimated usable period; and 4. other long term expenses : 3 years. 	<p><i>The earlier drafts of the CITLIR define “other long term expenses” to include pre-operating expenses. The final CITLIR however is silent on this. Under IFRS (which should be adopted by all listed companies in China), pre-operating expenses are no longer classified as long term amortizable expenses but rather as current expenses. Under the Chinese GAAP (which still applies to non-listed companies in China), pre-operating expenses are written off in the first year of operation. This being the case, the tax treatment of pre-operating expenses is now unclear. We will have to wait for further guidance from the SAT.</i></p>

<u>CITL</u>	<u>CITLIR</u>	<u>Remarks</u>
	<p><i>Article 75</i></p> <p>States that gains or losses arising from group reorganizations shall be recognized and the taxation basis of the relevant assets should be adjusted according to transaction value unless otherwise provided for.</p>	<p><i>The section dealing with taxation treatment of group reorganizations appearing in earlier drafts is left out in the final CITLIR. We believe the SAT will issue separate circulars to further clarify these tax issues. As the CITLIR now stands, and unless new circulars are issued, the tax-free transfer of shares of a Chinese subsidiary from a foreign holding company to another foreign holding company with 100% common ownership currently permissible under Circular Guoshuihan [1997] No. 207 will be gone.</i></p>
<p><i>Article 24</i></p> <p>A resident company receiving dividends from an overseas company directly or indirectly controlled by it can claim as a tax credit the relevant underlying income tax paid by the investee company.</p>	<p><i>Article 80</i></p> <p>Defines “control” to mean a shareholding of more than 20%.</p>	

(4) Clarifications on Chapter 4 of the New CITL (i.e., Tax Concessions)

<u>CITL</u>	<u>CITLIR</u>	<u>Remarks</u>
<p>Article 26</p> <p>Dividend income received by a resident company from another resident company is non-taxable under certain conditions.</p>	<p>Article 83</p> <p>The conditions are:</p> <ul style="list-style-type: none"> • the non-taxability only applies to dividends arising out of a direct equity investment • such equity investment does not include investment in the listed shares of a resident company held for less than 12 months. 	
<p>Article 27</p> <p>Provides for reduction or exemption of tax on certain income, including:</p> <ol style="list-style-type: none"> 1. Income from agricultural, forestry, animal husbandry and fishery projects; 2. Income from infrastructure projects; 3. Income from environmental protection and energy and water conservation projects; 	<p>Articles 86 to 88</p> <p>List the various types of projects eligible for tax reduction and exemption (Note 1). There will be a Catalogue issued for eligible infrastructure projects (Note 2).</p>	<p><i>(Note 1)</i> <i>The incentives vary from complete exemption to 50% reduction (agricultural, forestry, animal husbandry and fishery), to a fixed period tax holidays of 3 years exemption and 3 years of 50% reduction (infrastructure, environmental protection and energy and water conservation).</i></p> <p><i>(Note 2)</i> <i>The Catalogue will be jointly issued by MOF and SAT in consultation with the relevant industry supervisory ministries.</i></p>

<u>CITL</u>	<u>CITLIR</u>	<u>Remarks</u>
<p><i>Article 27 (cont'd)</i></p> <p>.. reduction or exemption of..</p> <p>4. Income from technology transfers under certain conditions; and</p>	<p><i>Article 90</i></p> <p>For resident enterprises transferring technology, the first RMB5 million is exempt, while the amount over and above that limit will enjoy a 50% exemption.</p>	
<p><i>Article 27 (cont'd)</i></p> <p>.. reduction or exemption of..</p> <p>5. Certain passive income (e.g., dividends, interest, rental, royalties, gain from transfer of assets, etc.) received by non residents.</p>	<p><i>Article 91</i></p> <p>Withholding tax on passive income will be reduced to 10% (instead of 20%).</p> <p>In addition, the following will be exempt:</p> <ul style="list-style-type: none"> • interest arising from loans made by foreign government to the Chinese government; • interest arising from loans made by international financial organizations to Chinese Government and resident companies at preferential terms. 	

<u>CITL</u>	<u>CITLIR</u>	<u>Remarks</u>
<p><i>Article 28</i></p> <p>A preferential income tax rate of 15% shall be applicable to “High-New Technology” companies designated by the State.</p>	<p><i>Article 93</i></p> <p>A High-New Technology company is defined as a company possessing the following characteristics:</p> <ul style="list-style-type: none"> • an owner (Note 3) of core proprietary intellectual properties; • recognized as within the territory of High-New technology supported by the Chinese Government (to be further defined by the Science and Technology Commission, the Ministry of Finance and the State Administration of Taxation); • annual R&D outlay not less than a prescribed percentage (Note 4) of annual turnover; • income from High-New technology product or service more than a prescribed percentage (Note 4) of the company’s total income; • R&D personnel shall be more than a prescribed percentage (Note 4) of the total employees. 	<p><i>(Note 3)</i> <i>What amounts to ownership is not further defined. It is still unclear as to whether economic ownership as opposed to legal ownership will suffice.</i></p> <p><i>(Note 4)</i> <i>Although specific percentages appeared in earlier drafts, the final CITLIR chooses to leave these open. We will have to wait for the release of further circulars from the SAT to see what these percentages are. The fact that the percentages are left out in the CITLIR also means the SAT will have the flexibility to specify different percentages for different industries. It may also mean that the percentages can be changed as often as the SAT wishes.</i></p>

<u>CITL</u>	<u>CITLIR</u>	<u>Remarks</u>
<p><i>Article 30</i></p> <p>Provides for super deduction of costs incurred for the following:</p> <ol style="list-style-type: none"> 1. R&D; and 2. Wages for disabled employees. 	<p><i>Articles 95 and 96</i></p> <p>Provide for a 150% deduction for R&D costs and 200% for disabled employees' wages.</p>	
<p><i>Article 31</i></p> <p>Venture capital companies are eligible to use a certain percentage of total investment to offset taxable income.</p>	<p><i>Article 97</i></p> <p>Provides that a Venture capital company investing in the equity of a non-listed small or medium High-New Technology company for more than 2 years can, upon reaching the 2 years ownership, use 70% of its investment to offset taxable income for that year. The excess not yet offset can be carried forward to future years.</p>	
<p><i>Article 32</i></p> <p>Allows accelerated depreciation on certain fixed assets.</p>	<p><i>Article 98</i></p> <p>Stipulates conditions to be met before accelerated depreciation can apply to include fixed assets subject to rapid technological obsolescence, and those exposed to constant shocks and erosion. The depreciation can either be a shortening of years of tax depreciation by not more than 40%, or use of the double reducing balance or sum of years digit method.</p>	

<u>CITL</u>	<u>CITLIR</u>	<u>Remarks</u>
<p><i>Article 33</i></p> <p>Companies generating income from engaging in recycling business is eligible for certain reduction in taxable income</p>	<p><i>Article 99</i></p> <p>Clarifies that recycling business refers to the use of raw materials listed in a Catalogue of Incentives for Recycling Businesses (see Note 2 above). The taxable income from such business can be 90% of the total income.</p>	
<p><i>Article 34</i></p> <p>Enterprises that purchases special equipment which are environment friendly, conserve energy or water, raise manufacturing safety, etc. can claim a certain percentage of the investment in such equipment as a tax credit.</p>	<p><i>Article 100</i></p> <p>Clarifies the preferential treatment to be a 10% of the purchase price of the equipment as income tax credit for the year in which the equipment is purchased. Excess credit can be carried forward for 5 years. Equipment disposed of or leased out within 5 years will have the credit clawed back accordingly. There will be a catalogue issued for eligible equipment (see Note 2 above).</p>	

(5) Clarifications on Chapter 6 of the New CITL (i.e., Anti-avoidance Tax Adjustments)

<u>CITL</u>	<u>CITLIR</u>	<u>Remarks</u>
<p><i>Article 41</i></p> <p>Permits cost allocation agreements among related parties on an arms length basis.</p>	<p><i>Article 112</i></p> <p>Provides for allocating costs jointly incurred on a matching principle (costs versus anticipated benefits) subject to filing such agreements with the tax authorities within a prescribed time limit.</p>	<p><i>Costs allocated without complying with the above requirements are not tax deductible.</i></p>
<p><i>Article 43</i></p> <p>Stipulates a compulsory transfer pricing (“TP”) documentation requirement. The article provides that upon a TP investigation by the tax authority, the company and its related parties must submit relevant documentation as required.</p>	<p><i>Article 114</i></p> <p>Clarifies that the “required documentations” include contemporary pricing policies, calculation methods and explanations, comparables, and profits level, etc.</p> <p>The documentation must be submitted by the taxpayer within the deadline imposed by tax authority.</p> <p>For related parties of the taxpayer and other companies included in TP investigation, the documentation must be submitted within an agreed time limit.</p>	<p><i>It does not appear that a TP specific fine or penalty is provided in the CITLIR on the absence of contemporary TP documentation. Interest imposed on owed tax per Article 48 of the CITL is applicable to all anti-avoidance adjustments including TP. If the TP documentation obligation is not met, the applicable interest on TP adjustment will not only be at the prevailing RMB lending interest rate published by the People’s Bank of China but also an additional 5%.</i></p>

<u>CITL</u>	<u>CITLIR</u>	<u>Remarks</u>
<p>Articles 44</p> <p>Tax authorities have the right to deem the amount of taxable income if taxpayers do not provide accurate and complete information to describe their intercompany transactions.</p>	<p>Article 115</p> <p>Prescribes the appropriate methods that tax authorities may consider in determining the deemed taxable income.</p>	<p><i>Tax authorities' right to deem taxable income is aimed at non-cooperative taxpayers that do not comply with contemporaneous TP documentation requirement. It can also be used in situations where taxpayers do not obtain cooperation from their affiliates.</i></p>
<p>Article 45</p> <p>Empowers the tax authority to recognize as taxable income the undeclared profits kept without good reasons by a controlled foreign subsidiary incorporated in a jurisdiction with a tax rate obviously lower than that of China.</p>	<p>The CITLIR provides details of what amounts to control, as well as the following definition:</p> <p>Article 118:</p> <p>A tax rate obviously lower than that of China means an effective tax burden lower than 50% of the China tax rate, i.e., 12.5%.</p>	
<p>Article 46</p> <p>Disallows interest deduction for loans from related companies in excess of a prescribed debt-equity ratio.</p>	<p>Article 119:</p> <p>Provides that “prescribed” debt-equity ratio would be formulated jointly by the Ministry of Finance (“MOF”) and SAT.</p>	<p><i>We will have to wait for the release of further circulars from the MoF and SAT to see what these ratios are.</i></p>
	<p>Article 123:</p> <p>The CITLIR specifically laid down a time limit for anti-avoidance tax adjustments including TP, CFC, thin capitalization and general adjustment on ground of no commercial substance etc. The statute of limitation is the tax authority can only go back 10 years at the most.</p>	

<u>CITL</u>	<u>CITLIR</u>	<u>Remarks</u>
<p><i>Article 48</i></p> <p>Interest shall be computed on owed tax.</p>	<p><i>Article 122</i></p> <p>Provides for an interest charge on the amount of tax payable under anti-avoidance adjustments at the RMB lending interest rate published by the People's Bank plus 5%.</p> <p>If a company can provide TP documentation within the statutory limit, the interest charge can be reduced to the RMB lending interest rate published by the People's Bank of China only (i.e., without the 5% add on).</p>	<p><i>Assuming a current RMB lending interest rate of 6%, the total interest charge therefore would be around 11% p.a.</i></p>
<p><i>Article 57</i></p> <p>This article lays down general principles for transitional arrangements relating to tax incentives enjoyed by companies under the old CITL</p>		<p><i>Surprisingly, the CITLIR is silent on further details of such transitional arrangements. We understand that SAT is considering the issue of a circular specifically dealing with this subject.</i></p> <p><i>Current indications are:</i></p> <p><i>Companies enjoying a 15% tax rate under the old CITLIR, can transition to the new 25% tax rate gradually in the following manner:</i></p> <ul style="list-style-type: none"> <i>• 2008 – 18%</i> <i>• 2009 – 20%</i> <i>• 2010 – 22%</i> <i>• 2011 – 24%</i> <i>• 2012 – 25%</i>

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