



Tax Feature

New Enterprise Income Tax Law in China

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In China, 2007 was an important year for enterprise income tax reform. This article aims at providing you with background information of the recent development of the new enterprise income tax law during 2007 and highlighting key elements you should be aware of when considering investing in China.

Background

On March 16, 2007, the National Peoples' Congress in China passed the New Enterprise Income Tax Law (NEITL), effective January 1, 2008.

The issuance of the NEITL is viewed as a milestone for China's enterprise income tax reform and brought China's corporate tax regime in line with other developed countries.

Before the issuance of the NEITL, domestic enterprises (DE) and foreign invested enterprises (FIE) in China were taxed under different enterprise income tax laws. The NEITL unified the enterprise tax law applicable to both DE and FIE.

The NEITL is a relatively short notice (it only contains 60 articles) and mainly sets out a framework guiding the future evolution of China's enterprise income tax regime. It introduces a number of significant rules, e.g., types of tax incentives available, anti-avoidance provisions, etc., without providing much detail.

On December 6, 2007, the State Council approved the detailed Enterprise Income Tax Law Implementation Rules (EITLIR), and it was publicly released on December 11, 2007. The EITLIR contains

133 articles and further elaborates some of the terms and rules mentioned in the NEITL.

As of yet, the EITLIR is far from complete, and further notices will be issued by various Chinese authorities from time to time addressing specific tax areas that have not yet been covered by the EITLIR. As of today, the State Council has passed and issued two additional notices, *GuoFa (2007) no.39* and *GuoFa (2007) no.40* on December 26, 2007, regarding the transitional and grandfathering treatments in respect to tax incentives offered under the old tax laws.

Key Issues Affecting Foreign Investors

If you plan to invest in China, you need to know how the NEITL and the EITLIR will affect your investment, and the degree of impact. In this section, we highlight the key areas contained in the NEITL and EITLIR that you should be aware of when formulating your China investment plan.

1. Enterprise income tax (EIT) rate

EIT rates effective January 1, 2008 are as follows:

Unified EIT rate effective January 1, 2008	25%
Small-scale/low-profit enterprises	20%
High/new technology enterprises	15%

Important – Although details regarding the qualification of high/new technology enterprises have not yet been released, investors should consider the technical contents of their investment which may have the potential to qualify for a lower preferential tax rate.

2. "Tax resident enterprise" and "non-tax resident enterprise"

The NEITL segregates enterprises into two categories: tax resident enterprises and non-tax resident enterprises. Tax resident enterprises will be subject to EIT on worldwide basis, while non-tax resident enterprises will only be subject to EIT on China sourced income.

The NEITL defines the meaning of "tax resident enterprises" to include enterprises incorporated outside China, e.g., a company incorporated under the laws of Hong Kong, with their place of effective management situated in China.

The "place of effective management" is elaborated in the EITLIR. Instead of merely looking at where the board of directors meetings of an enterprise are held, the EITLIR adopts a more comprehensive, but at the same time quite vague, approach to define the place of effective management as "the place where a substantive overall management and control of the production and business operation, personnel, accounting, properties, etc., of an overseas enterprise is situated." No universal rules are available to ascertain the tax residency of overseas enterprises, and each case will be assessed by reviewing its own facts.

Important – Foreign investors should plan carefully when formulating their investment in China to ensure that the overall management and control functions of their overseas business activities/units are not situated in China. Appropriate structures may be adopted to minimize the risk of being considered as a tax resident enterprise in China. Otherwise, their overseas business activities/units may be deemed as a "tax resident enterprise" and hence exposed to worldwide tax in China.

3. Withholding tax

Before January 1, 2008, dividends remitted to foreign investors from FIEs in China are exempt from withholding tax.

The NEITL indicates that effective from January 1, 2008, outbound China sourced passive income (including dividends, royalties, interest, etc.) will be subject to withholding tax at 20%. The EITLIR reduces the withholding tax rate to 10%.

Important – The removal of the withholding tax exemption on dividends can increase foreign investors’ overall global tax liability. Therefore, they should consider investing into China via intermediate holding companies set up in countries having favorable tax treaties with China. The investment structure should consider the investors’ exit strategy.

4. Tax incentives

The NEITL provides a number of tax incentives, including exemption or reduction in EIT rates, reduction in taxable income or tax payable and extra deduction on certain types of expenses. The EITLIR further elaborates the details of these tax incentives. However, many details are still pending further clarification.

Some of the tax incentives are discussed in detail below:

High/New Technology Enterprises – As mentioned above, qualifying high/new technology enterprises may enjoy a reduced EIT rate at 15%. According to the EITLIR, in order to obtain the “high/new technology enterprises” qualification, an enterprise is required to possess several characteristics, e.g., R&D personnel should be more than a prescribed percentage of total number of employees, which details will be promulgated later.

One of the characteristics is that a qualifying high/new technology enterprise should own a core proprietary intellectual property, which foreign investors are often reluctant to hold in China, given the inherent challenges with protecting intellectual property in China. Currently, it is uncommon for multinational corpora-

tions to transfer the ownership of their core proprietary intellectual properties to their Chinese subsidiaries due to various reasons, including intellectual properties protection concerns. In addition, there are potentially severe U.S. income tax consequences associated with transferring intellectual property to a foreign corporation.

Important – Even the NEITL provides such preferential EIT rate to qualifying high/new technology enterprises. Foreign investors should consider the pros and cons before transferring the ownership of their core proprietary intellectual properties to their Chinese subsidiaries.

Venture Capital Enterprises – A venture capital enterprise investing in the equity of a non-listed small or medium high/new technology enterprise for more than two years can credit 70% of its investment amount against its taxable income with an indefinite carry-forward period.

Tax Exemption/Reduction on Income from Encouraged Projects – Some general preferential tax treatments granted under the old tax laws are no longer available under the NEITL. Instead, preferential tax treatments are granted depending on the types of projects invested by investors.

Income derived from eligible encouraged projects can either be exempted from EIT or enjoy a reduced EIT rate.

Encouraged projects include those in Table 1 below.

Detailed requirements regarding the qualification of these projects have not yet been promulgated.

5. Grandfather rules

The State Council has passed and issued two notices, *GuoFa (2007) no.39* and *GuoFa (2007) no.40* on December 26, 2007, regarding the transitional and grandfathering treatments in respect to tax incentives offered under the old tax laws.

GuoFa (2007) no.39 – This notice provides the grandfathering treatment for enterprises (both DEs and FIEs), which have obtained business licenses before March 16, 2007 and are entitled to preferential tax treatments under the old tax laws.

This notice confirms the following:

- a. Enterprises subject to a reduced tax rate of 15% before 2008: The EIT rate will increase gradually over five years according to the following table:

Year	EIT rate
2007	15%
2008	18%
2009	20%
2010	22%
2011	24%
2012	25%

- b. Enterprises subject to a reduced tax rate of 24% before 2008: The EIT rate will increase to 25% in 2008.
- c. Various tax holidays under old tax laws (most of the tax holidays were only available to FIEs, while some were also available to DEs):
 - For those enterprises that have already started their tax holidays before 2008, they are able to enjoy the remaining tax holidays until expiration

Table 1 – Encouraged Projects & Tax Incentives Available

Type of projects	Tax incentives available
Agricultural, forestry, animal husbandry and fishery projects	Exemption from EIT or 50% tax reduction
Infrastructure projects	Three years exemption from EIT, plus three years half tax reduction period
Environmental protection, energy and water conservation projects	

- For those enterprises that have not yet started their tax holidays before 2008, the tax holidays will be deemed to start from January 1, 2008, and they are able to enjoy the remaining tax holidays until expiration

GuoFa (2007) no.40 – This notice mainly addresses the tax incentives available to high/new technology enterprises newly established, *i.e.*, established after January 1, 2008, in certain locations, as stipulated under Article 57 of the NEITL. Details as follows:

- There are six zones, including five economic zones (Shenzhen, Zhuhai, Shantou, Xiamen and Hianan) and Shanghai Pudong New Area
- These newly established high/new technology enterprises should comply with the requirements stipulated by the NEITL and EITLIR (discussed in Section 4 above)
- Tax incentives available to these enterprises are “2 years exemption followed by 3 years half tax reduction.” The tax holiday will commence in the year when the enterprise starts generating income

6. Anti-avoidance provisions

The NEITL introduces a number of anti-avoidance provisions and the EITLIR further elaborates the same.

Anti-avoidance rules include:

- Compulsory transfer pricing (TP) documentation requirement
- Thin capitalization provision
- Controlled foreign corporation (CFC) provision
- General anti-avoidance provision

EITLIR does not provide a very detailed elaboration of the above rules, and further guidance will likely be issued subsequently.

Of the above anti-avoidance provisions, TP may pose the biggest challenges to foreign investors. After the issuance of the NEITL and EITLIR, it is expected that the Chinese tax authorities will turn their focus to TP regulations and enforcement.

Important – When formulating the investment plan in China, foreign investors should consider the basis and calculation methods of inter-company pricing adopted in transactions with related companies. In addition, foreign investors need to ensure related party transactions are properly supported by documents. Assistance from a professional is highly recommended. Related party service fees may be deductible, but such fees should be arm’s length and supported with proper transfer pricing documentation.

7. Deductions

According to the NEITL and EITLIR, deductibility of some expenses are limited to certain levels or restricted to certain conditions. See Table 2 below.

Closing Comment

The issuance of the NEITL and EITLIR marks the launch of China’s enterprise income tax reform, but there is still a long way to go. There are still a lot of uncertainties surrounding the NEITL, and further explanations from

the Chinese tax authorities will be announced from time to time. During this transitional period, we expect that foreign investors investing in China will likely be facing uncertainties on various tax positions over many important areas.

We will closely follow future developments of the China enterprise income tax reform. Questions will arise after reading this alert. Further professional opinion may be required.

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Table 2 – Deductibility of Some Expenses is Limited or Restricted

Type of expense	Treatment
Entertainment expenses	60% of expenses are tax deductible, subject to a cap of 0.5% of annual turnover
Goodwill acquired	Not deductible until disposal or liquidation
Advertising and promotion expenses	Capped at 15% of annual turnover and remained portion can be carried forward for future deduction
Employee welfare expenses	Deductible up to 14% of total salaries
Employee education expenses	Deductible up to 2.5% of total salaries
Charitable donations	Deductible up to 12% of accounting profit