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## New Corporate Income Tax Law in China

The new Corporate Income Tax (CIT) Law, enacted on 16 March 2007, with its Detailed Implementation Rules (DIR) officially issued on 11 December 2007, became effective on 1 January 2008. The CIT Law and DIR unify the corporate income tax treatments of domestic and foreign enterprises by consolidating the Enterprise Income Tax (EIT) Law, applicable to domestic Chinese enterprises, and the Foreign Enterprise Income Tax (FEIT) Law, applicable to foreign enterprises and foreign-invested enterprises. The EIT and FEIT Laws ceased to be effective on 1 January 2008.

The new CIT Law and DIR affect the tax rates, tax incentives and certain tax rules of foreign enterprises and foreign-invested enterprises.

### Tax Rates

Under the CIT Law, enterprises are divided into two categories: tax-resident enterprises and non-tax-resident enterprises. Tax-resident enterprises are enterprises that are incorporated under People's Republic of China (PRC) laws, as well as enterprises not incorporated under PRC laws but with an effective management institution in China. Enterprises incorporated under foreign laws are non-tax-resident enterprises. The global income of tax-resident enterprises and the China-sourced income of non-tax-resident enterprises are subject to the CIT Law.

#### *Tax Rate for Tax-Resident Enterprises*

Foreign-invested enterprises are incorporated and registered under PRC laws and are therefore tax-resident enterprises. Thus, the global income of foreign-invested enterprises shall be subject to the CIT Law at a tax rate of 25 per cent.

Foreign enterprises with effective management institutions in China are also tax-resident enterprises, and their global income shall be subject to the CIT Law at a tax rate of 25 per cent. An effective management institution is defined as an institution that exercises a substantial or complete control over the business operation, human resources, finance and properties, *etc.*

Foreign enterprises should review their management and control functions within China for their overseas business activities, and take precautionary actions to avoid being deemed a tax-resident enterprise and exposing their global income to Chinese taxation.

#### *Tax Rate for Non-Tax-Resident Enterprises*

Which CIT Law tax rate applies to non-tax-resident enterprises depends on whether they have an establishment in China. Foreign enterprises with an establishment in China are non-tax-resident enterprises and shall be subject to the CIT Law at a tax rate of 25 per cent, with respect to their China-sourced income and their global income that has a *de facto* relationship with the establishment.

The DIR's definition of an establishment is broader than most tax treaty definitions, in that the appointment of any business agent in China to store and deliver goods constitutes an establishment. This means that non-treaty-protected principals in many supply-chain structures may be treated as having establishments.

China is aggressively seeking to treat the performance of consulting and other services as an establishment, even where the service provider does not have a place of business in China. Although tax treaties generally provide a "more than six months" rule, the DIR is silent as to the length of time required to constitute an establishment in China.

Foreign enterprises without an establishment in China are non-tax-resident enterprises in China, and the dividends, interests, royalties, rent and gains received by them are subject to withholding tax at a rate of 10 per cent.

Considering that China has entered into a number of tax treaties (*e.g.*, with Hong Kong) that provide for a lower 5 per cent withholding tax for qualifying investors, ownership structuring may be appropriate. However, any such planning should take into account the general anti-avoidance DIR in the new CIT Law.

#### *Tax Rate for Foreign-Invested Enterprises in the Five-Year Transitional Period*

Many manufacturing foreign-invested enterprises established before 16 March 2007 are currently enjoying a 15 per cent tax rate because of the “two plus three” tax holiday (a two-year exemption from tax followed by three years at half the regular tax rate) and geographic incentives. Although the DIR remains silent on how the 15 per cent rate will gradually be increased to 25 per cent, tax authorities have confirmed the following transitional arrangement on several occasions:

FEIT Regime Actual Percentage	CIT Regime Actual Percentage	Actual Percentage in the Transition Period
33%	25%	Change took place on 1 January 2008
24%	25%	Change took place on 1 January 2008
15%	25%	The rates will gradually increase in the following manner: 2008 18% 2009 20% 2010 22% 2011 24% 2012 25%

Foreign-invested enterprises established after 16 March 2007 will not be allowed to enjoy the transitional income tax rate stated in the above table. Numerous non-manufacturing enterprises located in Pudong have enjoyed a 15 per cent tax rate despite the lack of an official law providing for this beneficial treatment. The grandfather rule may not apply to such enterprises, which would cause their tax rate to rise immediately to 25 per cent.

#### Tax Incentives

The tax incentives under the new CIT Law are industry-oriented, rather than geography-oriented. The CIT Law abolishes the existing tax incentives for foreign-invested enterprises in special regions, and instead offers incentives for high-tech, infrastructure, agriculture, environmental protection and energy saving industries.

#### *Tax Incentives for High-Tech Enterprises*

The tax rate for high-tech enterprises is 15 per cent. As the principal remaining incentive in which foreign investors have an interest, the criteria for high-tech enterprise status have been eagerly anticipated. An important area of concern for foreign investors has been previous indications that this status would require legal ownership of intellectual property (IP). In the DIR, the stated criteria are as follows:

- Investor has independent ownership of “core IP rights”. The Chinese language for this criteria is unclear regarding whether “economic ownership” of IP without legal title will be sufficient. Because many foreign investors have concerns about registering their IP ownership in China, this is an important issue.
- Products/services are included in the State Encouraged High and New Technology Catalog. This catalog is to be released by the State Council and the science, tax and finance bureaus.
- Research and development expenditure exceeds a minimum required percentage of annual sales revenue.
- Income from high-tech product sales or services exceeds required percentage of total revenue.
- Number of research and development personnel exceeds required percentage of all employees.

The various required percentages and any additional requirements are expected to be provided in a future circular or other guidance.

While the DIR provides little guidance on the definition of qualifying research and development expenditure, it does refer to the development of new technologies, new products and new techniques. The DIR is silent regarding any requirement that IP

resulting from research and development efforts be legally owned by the enterprise conducting the research and development work.

The DIR provides that any qualifying research and development expenditure properly chargeable to the income statement will be allowed an additional 50 per cent super deduction. For any such expenditure capitalized as intangible assets, 150 per cent of the cost of the intangible asset will be the basis for amortization.

Qualifying transfers of technology by tax-resident enterprises shall be subject to tax exemption with a cap of RMB5 million for income earned in a taxable year from the transfer of ownership of technologies, and any excess shall be subject to a 50 per cent reduction in the normal 25 per cent tax rate. However, such transfer must be the transfer of the ownership of the technology. Any form of licensing is not applicable for this incentive.

Where a venture capital enterprise invests in the shareholdings of private, small or medium-sized, new and high-tech enterprises for more than two years, 70 per cent of the investment amount may be deducted from taxable income in the year when the two-year holding is completed. Unutilized deductions may be carried forward to future tax years.

#### *Industry, Infrastructure and Environmental Incentives*

Numerous activities in the agricultural, forestry, animal husbandry and fishery industries are subject to full exemption. Several others are allowed a 50 per cent reduction in the normal 25 per cent tax rate.

Among major state-supported public infrastructure facility projects, qualifying initiatives include pier and dock projects, airports, railroads, roads, urban public transportation, electricity projects and water resources utilization projects, among others. From their first revenue-producing year, qualifying projects will be granted a three-year tax exemption, followed by a three-year 50 per cent reduction in the normal 25 per cent tax rate.

For environmental protection and water or energy saving projects, covered initiatives include public wastewater treatment, public refuse treatment, comprehensive exploitation and utilization of bio-gas, upgrade of energy-saving/pollution reduction technologies and seawater desalination projects, among others. From their first revenue-producing year, qualifying projects will be granted a three-year exemption, followed by a three-year 50 per cent reduction in the normal 25 per cent tax rate.

#### *Anti-Avoidance Tax Rules*

The DIR requires “contemporaneous documents” regarding related-party transactions, such as pricing, standards for determining expenditures, computation methods, explanatory notes, *etc.* Although it is unclear what specifically must be filed with the annual tax return as opposed to merely being held for a future tax examination, it is expected that guidance on this will be issued soon. Confirmation is still pending, but it appears that 2008 is the first tax year for which contemporaneous documents must be prepared.

Furthermore, for an adjustment involving transfer pricing or the general anti-avoidance rule, the tax authorities have the right to make tax adjustments within 10 years from the tax year in which the transaction occurred.

#### *Cost-Sharing Arrangements*

Although the CIT Law provides that cost-sharing arrangements may cover the joint development of intangible assets and the provision of labor services, the DIR merely acknowledges that an enterprise may share costs with its related parties. The DIR requires that allocations be based on the principle that the costs and expected benefits are matched. Without providing any details, the DIR requires that an enterprise sharing costs must file relevant documents in a timely manner and in accordance with the tax authorities’ requirements. Further guidance should be forthcoming.

#### *Thin Capitalization Rule*

Interest arising from related-party debt exceeding a certain rate shall not be deducted before tax. Currently, the definition of related-party debt is unclear. Accordingly, a definition of “related party” will likely follow the transfer pricing DIR.

The DIR does not specify a percentage for related-party status for transfer pricing purposes. The current percentage for transfer pricing purposes is 25 per cent. Whether this percentage will change is subject to future guidance. The debt to equity ratio is still unclear and subject to further circular issued by financial and taxation authorities.

#### *Controlled Foreign Companies Rule*

If the income of a controlled foreign company (CFC) is not distributed to the tax-resident enterprise, or is under-distributed to the tax-resident enterprise, and such arrangement is without justifiable commercial reasons, such income shall be taxed in China.

The DIR provides a definition of a CFC that follows the U.S. CFC statutory definition. As such, a foreign enterprise is a CFC when China-resident enterprises and individuals each directly or indirectly hold 10 per cent or more of total voting shares, and jointly hold more than 50 per cent of total shares. There is also a “substantial control” provision when these percentage tests are not met. The DIR provides that the effective tax rate of the foreign enterprise must be less than 12.5 per cent (less than 50 per cent of China’s tax rate) for it to be subject to the CFC provisions. It is expected that considerable additional guidance will be provided later.

#### *Interest on Tax Adjustments*

The DIR provides for nondeductible interest to be charged on underpayments from 1 June following the tax year until the date of payment. Where an underpayment arises from transfer pricing, CFCs, thin capitalization or general anti-avoidance rule issues, the interest charged will be calculated in accordance with the standard renminbi loan interest rate for the same period as the underpaid tax published by the People’s Bank of China, plus an additional 5 per cent. Based on the current rates announced by the Peoples Bank, the combined rate is likely to be 12 per cent or higher. Note that the additional 5 per cent will not be charged where the underpayment relates to transfer pricing and all documentation requirements have been satisfied (including the contemporaneously required documents).

Clearly, the DIR is far from answering all the ambiguous expressions in the new CIT Law. Significant uncertainties still remain regarding the tax treatment of enterprise restructuring and liquidations, the five-year grandfathering period and the taxation for partnership enterprises in China, among other issues.

Investors must familiarize themselves with the CIT Law and its DIR, be prepared to revamp their Chinese tax planning and risk management strategies, and remain alert for further development.