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Interpreting the New Enterprise Income Tax Law

By Wenjie Sun

On March 16, 2007, the fifth session of the 10th National People's Congress passed a new corporate income tax law entitled the "Law of the People's Republic of China on Enterprise Income Tax" (the "EIT Law"). The new EIT Law will take effect on January 1, 2008.

Since China's economic reforms began in the 1980's, foreign invested enterprises (FIEs) and domestic enterprises have been subject to different tax policies; due to prevailing economic objectives, FIEs were, in fact, given more favorable treatment in relation to corporate income taxes. The current FIE income tax regime was established in 1991 by the "Law on Income Tax of Foreign Investment Enterprises and Foreign Enterprises" (the "FEIT Law"). On the other hand, the applicable system for domestic firms was established in 1993 through the promulgation of the "Interim Regulations on Income Tax of PRC Enterprises".

Under the current regime, FIEs may enjoy a 24% or 15% rate for corporate income tax while domestic firms and non-qualifying FIEs are subject to a 33% tax rate. Among other incentives, the FIE Tax Law grants a "two-plus-three" year tax holiday to FIE manufacturers, which means a two-year exemption during the first two profit-making years plus three-years at half the applicable rate. It is said that under the current system, actual corporate income tax rate for FIEs was 11% on average, which is only one-third of that applicable to domestic firms. From a numbers perspective, the new EIT Law is projected to result in as much as an RMB93 billion loss to government revenue, of which domestic enterprises will benefit from RMB134 billion in reductions and FIEs will be subject to a RMB41 billion increase.

It is clear that these changes signify a new direction for the world's sixth-largest economy, in relative terms, decreasing its attractiveness as a destination for FDI, while strengthening domestic industry on the international stage.

As expected, the new EIT Law aims to unify tax treatment among FIE's and domestic enterprises not only through a unified tax rate but also an overall unification of the corporate income tax system.

This aim is reflected in following respects:

1. Unified tax rate

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In Article 4, the EIT Law provides that the enterprise income tax rate will be 25% regardless of whether it is a domestic or foreign invested enterprise. Compared with the current regime, the new law reduces domestic enterprises' income tax while increasing that of foreign invested enterprises.

2. Unified tax deduction

Under the current system, a domestic company is subject to more limitations than its FIE counterpart in terms of pre-tax deductions; for instance, the standard for domestic company's salary deduction is much lower than an FIEs. In the new law, all deductible items are set forth in Chapter 2, which unifies the standard for all enterprises.

Article 9 of the EIT Law brings significant social progress, which is considered to be an incentive for corporate shareholders to make charitable donations. It states that an enterprise's charitable donations will be deductible from taxable income to the extent that is within 12% of the year's total profits.

Enterprise income tax rate will be at a rate of 25% regardless of whether it is a domestic or foreign invested enterprise

Article 4 of the New EIT

3. Unified favorable treatment

Under the current regime, the majority of favorable tax policies are only available to FIEs and depend largely on location; for instance, manufacturers established in development zones, industrial parks, or special economic zones may enjoy the lowest rate of 15%. Favorable treatments in the new EIT Law will be based more on industrial sector rather than region of investment. Enterprises in high-tech, state-supported and state-encouraged sectors will enjoy a lower rate or tax deductions. (Definitions of qualifying enterprises are intentionally undefined in the law, as this will change with government policy.) Favorable tax rates will be also extended to other encouraged sectors such as environmental protection, energy conservation projects and agricultural infrastructure. All of these preferential policies will be adopted across the country, rather than focusing on specific regions. Furthermore, the new law will firstly apply a lower rate of 20% to small-sized enterprises with low profits.

It is without question that enforcement of the new law will abolish the majority of the favorable tax treatments currently enjoyed by FIE's, including:

- "Two plus three" holiday applicable to foreign invested manufacturers;
- Three-years holiday extension applicable to high-tech FIEs;
- 15% or 24% rate applicable to FIEs in certain regions;
- 50% reduction applicable to export-oriented FIEs;
- Income tax refund for re-investments in China.

However, the new law grants a 5-year grace period to existing FIEs allowing them to gradually increase the current 15% or 24% rate enjoyed to the unified 25% within the period; for instance, if an FIE is enjoying a 15% rate at present, from 2008 the tax rate will increase 2% each year until it reaches 25%. The new law also allows enterprises registered in certain special economic zones to enjoy a grace

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period, however, such policies will be otherwise made by the State Council.

4. Anti-avoidance

The new law introduces Chapter 6 entitled "Special Taxable Adjustments", in which more anti-tax-avoidance provisions will be enforced. For example, in Article 41, it stipulates that if an enterprise engages in a transaction which is against the independent trade principle and reduces taxable income, with an affiliated company, the tax authority has the power to make adjustment.

Special Taxable Adjustments were introduced, allowing certain flexibility for the tax authority to make adjustments

Among the anti-avoidance measures, the new law also introduces a new "controlled foreign corporate" rule. Under this new rule, if a foreign company registered in a low-tax jurisdiction is controlled by corporate taxpayers in China, the Chinese tax authorities may consider those undistributed profits made by that foreign company as the controlling company's taxable income.

Provisions in Chapter 6 also reflect that the new law will implement stricter measures in controlling and monitoring transfer pricing. It requires the enterprise to submit a report indicating transactions with affiliated companies. Of course, if the authorities find any unusual price arrangements, the enterprise in question will be required to provide more documentation and adjustments may eventually be made by the authorities.

Like most NPC legislations, the new EIT Law leaves room for argument and further implementation rules.

5. Withholding tax

Under the new law, incomes generated in China by a foreign company that has no subsidiary or office registered in China will be subject to a 20% withholding income tax rate prior to remission of income to sources outside of China. Withholding tax may apply where a foreign company receives a license fee, franchise fee, or service fee from its Chinese partners. Currently, the withholding income tax applies 10% generally and 5% for Hong Kong companies according to CEPA. (These rates were set, directly or indirectly, by the central government.) The new law authorizes the State Council to make detailed implementation rules; therefore it is expected that the implementation rules will maintain the current rates. However, it is important that investors consider/re-consider structuring of their Special Purpose Vehicle for China investments.

6. Resident Enterprises and Non-resident Enterprises

Article 2 of the new EIT Law makes a distinction between enterprises which are "Resident Enterprises" and "Non-resident Enterprises". Resident Enterprises are defined as "enterprises incorporated in China or incorporated in other jurisdictions but having *management organizations* in China. Non-resident Enterprises are defined as "enterprises incorporated in other jurisdictions and with offices but *no management organizations in China*, or without offices and management organizations but having income generated in China".

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Under the new law, Resident Enterprises and Non-resident Enterprises are subject to different rates, 25% and 20% respectively. Further, global income for Resident Enterprises will be subject to China taxation. The question is how does one determine whether it has a *management organization* in China? This aspect also requires further clarification through implementation rules to draw a line between which companies incorporated in other jurisdictions outside of China are considered to be Resident Enterprises. This will assist foreign incorporated enterprises in determining corporate structuring, impacting on their classification as resident or non-resident.

For new investors, the tax law will, obviously, affect its decision whether or not to come to China. Further, for current FIE's, there is an even greater need to re-examine corporate structures in order to strategically minimize tax burden given the increased complexity of the tax system and less-favorable treatment afforded to foreign investors.

It is difficult to determine whether the new EIT Law will impact on foreign investment in China. Among other elements such as low labor costs, low price of raw materials, and a huge market, the existing favorable tax treatment is but one of many. However, for domestic firms, the new law will definitely enhance their competitiveness on the international market.

We will be providing a regular update on any changes or issuances of regulations affecting the new corporate tax rate. For any specific inquiries, please see our contact information below.

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