

# China Tax & Investment News



## *Further Light Shed on Preferential Corporate Income Tax Policies*

### INTRODUCTION

The Ministry of Finance (the “MOF”) and the State Administration of Taxation (the “SAT”) jointly issued a circular Caishui [2008] No. 1 (hereinafter referred to as the “Circular 1”) on 22 February 2008 announcing the approval by the State Council of certain preferential tax policies. These policies are additions to those previously enacted under the new Corporate Income Tax Law (the “CITL”), and are formulated under the power granted by the People’s Congress (the highest legislative body in the Mainland China) to the State Council under Article 36 of the CITL. Under Article 36, the State Council is empowered to announce special preferential tax policies pursuant to the social and economic development needs of the country, as well as counteracting the impact of unexpected events on the business operations of enterprises. Circular 1 is the first application of Article 36 by the State Council, and we believe that it will not be the last.

This issue of the China Tax & Investment News (the “News”) summarizes the new preferential tax policies, analyses the potential impacts, and recommends actions to be taken by companies.

### NEW PREFERENTIAL TAX POLICIES

Circular 1 provides preferential tax policies to certain specific industries, assets and earnings.

#### *Preferential Tax Policies for Specific Industries*

##### 1. Software development industry

- Value Added Tax (“VAT”) refunds received by software development enterprises shall not be included as taxable income under CIT if the VAT so refunded is utilized for the research and development of software products, or for the expansion of production capacity.
- Subject to verification, newly established software development enterprises may enjoy two years exemption, followed by three years of 50% reduction of CIT otherwise payable from the first profitable year. It is interesting to note that Circular 1 accords eligible taxpayers special tax holidays from the first profitable year after offsetting previous losses, whereas the CITL Implementation Regulations (the “CITLIR”) and Guofa [2007] No. 40 accords eligible taxpayers tax holidays from the first income generating period.
- For key software development enterprises under the State’s planning (i.e., those certified jointly by the State Development and Reform Commission, the Ministry of Information Industry, the Ministry of Commerce and the SAT under a circular Fagaigaoji [2005] No. 2669 ([发改高技[2005]2669号]), the applicable CIT rate can be reduced to 10%.

- Employee training expenses actually incurred by software development enterprises can be fully deductible for CIT purposes, i.e., not subject to the annual limitation to 2.5% of the total salaries and wages under Article 42 of the CIT Law Implementation Regulations.

(N.B. The term “training expenses” is not further defined in Circular 1, and it appears that it should be given the same meaning as the similar term used in Article 42 of the CITL.)

## 2. Integrated circuit (“IC”) production industry

- IC design enterprises will be recognized as equivalent to software development enterprises and entitled to the preferential tax policies described in the section above.
- With approval from the tax authorities, the depreciation period of the production machinery and equipment of IC manufacturing enterprises may be shortened, subject to a minimum tax depreciation period of not less than three years.
- For IC manufacturing enterprises with a total investment exceeding RMB 8 billion, or IC line width of less than 0.25 $\mu$ m, the applicable CIT rate can be reduced to 15%. Such IC manufacturers may be entitled to five years exemption followed by another five years of 50% reduction in CIT payable, from the first profitable year after offsetting previous losses, PROVIDED THAT the approved operation period of such enterprises is longer than 15 years.
- IC manufacturing enterprises producing products with IC line width equal to or less than 0.8 $\mu$ m may be entitled to two years exemption followed by three years of 50% reduction in CIT payable from the first profitable year. However, if the IC manufacturers have already enjoyed the two-plus-three tax holidays from the first profitable year, this provision shall not apply.
- During the period from 1 January 2008 to 31 December 2010, investors of an IC manufacturing enterprise or IC encapsulation enterprise may receive a refund of 40% of the underlying CIT paid if they reinvest the after-tax profits in increasing the registered capital of the same enterprise, or in establishing another IC manufacturing or IC encapsulation enterprise, PROVIDED THAT the reinvestment is not less than five years. If the reinvestment is withdrawn within five years, the CIT refunds shall be clawed back.
- For re-investments made by domestic or foreign economic organizations (国内外经济组织) from after-tax profits derived in the Mainland China into IC manufacturing enterprises, IC encapsulation enterprises or software development enterprises in the Western Region, the reinvestment tax refund may be increased to 80% of the underlying CIT paid, PROVIDED THAT the reinvestment period is not less than five years.

(N.B. Circular 1 does not specify the period of time within which the investors should apply for the reinvestment tax refund. In addition, “domestic or foreign economic organizations” is not fully defined and Circular 1 is not fully clear on whether or not foreign enterprises are considered as foreign economic organizations.)

## 3. Securities investment fund industry

- The following incomes derived from securities investment funds are exempt from CIT until further notice:
  1. Gains from trading in shares and bonds;
  2. Share dividends;
  3. Bond interest; and
  4. Other income.

- Income derived from investors in a securities investment fund is exempt from CIT until further notice.
- Income derived from trading in shares or bonds by fund managers is exempt from CIT until further notice.

#### 4. Other industries and enterprises

- Certain old tax incentives available to some industries or enterprises will continue until the expiry of the relevant regulations. The relevant regulations are summarized in a table attached to this News (see Appendix I).

#### ***Preferential Tax Policy for Specific Assets***

- For purchased software recognized as either fixed assets or intangible assets, enterprises may, with approval from the in-charge tax authorities, shorten the depreciation or amortization period, subject to a minimum of not less than two years.

#### ***Preferential Tax Policy for Specific Earnings***

- Distribution of retained earnings generated by FIEs prior to 1 January 2008, but repatriated to foreign investors after 1 January 2008, is exempt from CIT. Distribution of retained earnings generated by FIEs in 2008 and later years shall be subject to CIT.

### **A WORTH NOTING MESSAGE**

The last paragraph of Circular 1 carries an important message. It states that ALL tax benefits implemented before 1 January 2008, other than those covered by the new CITL, CITLIR, Guofa [2007] No. 39, Guofa [2007] No. 40 and Circular 1, will cease to apply. (Please refer to our Tax Alert issued in March 2007 and China Tax and Investment News Issues No. CTIN2007004 and CTIN2008001 for details of tax incentives covered by the new CITL, CITLIR, Guofa [2007] No. 39, and Guofa [2007] No. 40).

Local governments and departments are prohibited from providing any local preferential CIT tax treatments on their own.

### **RECOMMENDED ACTIONS**

According to the old CITL for FIEs, which contains similar reinvestment tax refund policies, foreign investors must apply for reinvestment tax refunds within one year after the actual injection of reinvested after-tax profits. On the assumption that similar procedures may apply to reinvestment tax refunds in software development, IC manufacturing or IC encapsulation enterprises under Circular 1, eligible investors should clarify with their in-charge tax authorities for the exact procedures to follow.

Now that all currently available tax preferential policies have been announced, finance and tax executives should carefully review what tax incentives their enterprises are entitled to, and if not, what those would mean for their market competitiveness. It is also the time for enterprises to critically examine their entire PRC operations and identify alternatives for improving their tax efficiency, if any. As the PRC CITL is not only new, but also complex and to a certain extent broad-brushed in some areas, extensive discussions with tax authorities and tax professionals are essential to the formulation of an efficient strategy.

## APPENDIX I

### Existing Preferential CIT Tax Treatment Regulations to be Applicable until Expiry

Categories	No.	Titles of Circulars	Remarks
Policies related to Employment and Re-employment	1	Notice issued by the MOF and the SAT on tax policies regarding re-employment of laid-off and unemployed workers (Caishui [2002] No. 208)	Enterprises approved on or before the end of 2005 for enjoying preferential tax treatments due to re-employment can continue to enjoy the remaining tax holidays until expiry
	2	Notice issued by the MOF and the SAT on tax policies regarding re-employment of laid-off and unemployed workers (Caishui [2005] No. 186)	The deadline for application and approval of tax preferential treatments under this notice shall be the end of 2008
Policies related to the Olympic Games and the World Expo	3	Notice issued by the MOF, the SAT and the General Administration of Customs (the "GAC") regarding tax policies for the 29th Olympic Games (Caishui [2003] No. 10)	The relevant tax policies shall cease after the closure of the Olympic Games and the completion of financial clearance by the Beijing Olympic Committee
		Notice issued by the MOF and the SAT regarding supplementary tax policies for the 29 <sup>th</sup> Olympic Games (Caishui [2006] No. 128)	
	4	Notice issued by the MOF and the SAT regarding tax policies for the Shanghai World Expo (Caishui [2005] No. 180)	The relevant tax policies shall cease after the closure of the Shanghai World Expo and the completion of financial clearance by the Shanghai World Expo Bureau
Approval issued by the MOF and the SAT regarding the eligibility of the Shanghai World Expo Operation & Management Co., Ltd. for preferential tax policies similar to the Shanghai World Expo (Caishui [2006] No. 155)			
Policies related to Social Benefit	5	Notice issued by the MOF and the SAT regarding the extension of duration of CIT exemption for enterprises manufacturing and assembling supplies for people with disabilities (Caishui [2006] No. 148)	

Categories	No.	Titles of Circulars	Remarks
Policies related to Debt/Equity Swaps, Asset Verification, Restructuring, Reform and Transformation of Enterprises	6	Notice issued by the MOF and the SAT regarding tax policies for enterprises implementing debt-equity swaps (Caishui [2005] No. 29)	
	7	Notice issued by the MOF and the SAT regarding the tax treatments of asset verification of central government enterprises (Caishui [2006] No. 18)	
	8	Notice issued by the MOF and the SAT regarding the extension of enforcement time limit of relevant tax policies concerning the transformation of specific research institutions (Caishui [2005] No. 14)	
	9	Notice issued by the MOF, the GAC and the SAT regarding tax policies after the conversion of cultural entities to enterprises during the course of the cultural system reform (Caishui [2005] No. 1)	
		Notice issued by the MOF, the GAC and the SAT regarding tax policies for the support of trial cultural entities development during the course of the cultural system reform (Caishui [2005] No. 2)	
Policies related to Agriculture and National Reserve	10	Notice issued by the MOF and the SAT regarding preferential tax policies for the promotion of farm produce chain operations (Caishui [2007] No. 10)	
	11	Notice issued by the MOF and the SAT regarding tax policies on television broadcasting over rural areas (Caishui [2007] No. 17)	
	12	Notice issued by the MOF and the SAT regarding tax policies for certain products belonging to the national reserve (Caishui [2006] No. 105)	

Categories	No.	Titles of Circulars	Remarks
Singleton Preferential Tax Policies	13	Notice issued by the MOF and the SAT regarding the tax policies for the stock right restructuring trial reform (Caishui [2005] No. 103)	This policy will be applicable until the end of the stock right restructuring trial reform
	14	Notice issued by the MOF and the SAT regarding the tax issues associated with China Securities Investor Protection Fund Limited Liability Company (Caishui [2006] No. 169)	
	15	Notice issued by the MOF and the SAT regarding the extension of enforcement time limit of relevant tax policies concerning rural cooperative funds (Caishui [2006] No. 46)	
		Notice issued by the MOF and the SAT regarding tax policies for the trial reform of rural cooperative funds in the Hainan Province (Caishui [2007] No. 18)	
	16	Notice issued by the MOF and the SAT regarding the continuance of tax policies applied to prison labour service and re-education enterprises (Caishui [2006] No. 123)	

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