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# Tax Alert

## China Corporate Income Tax Reform Has Tax Accounting Implications

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**The rapid and continual global changes in the business and tax environment have prompted companies to pay more attention to financial accounting for income taxes and management of tax risks. This Alert is designed to highlight the impact of the China Corporate Income Tax Reform on the accounting for income taxes.**

### Overview

On March 16, 2007, the 10th National People's Congress of China passed the China Unified Corporate Income Tax Law ("The New Law"). The New Law will become effective on January 1, 2008. The State Council will promulgate the related implementation rules and regulations details ("The IRR") within 2007. The IRR will give more details on the definition of various terms and the interpretation and application of the provisions of The New Law.

In addition to provoking significant tax compliance and tax planning considerations for all companies doing business in China, The New Law also presents significant income tax accounting implications on financial reporting under the PRC Generally Accepted Accounting Principles ("GAAP") and international accounting standards, such as US GAAP and International Financial Reporting Standards ("IFRS").

Of particular note, companies which are required to report interim results in the period running up from the date of enactment of The New Law (March 16 2007) to the date The New Law becomes effective (January 1 2008) have to evaluate, document and account for the impact of The New Law in their interim reports. Additionally, interim disclosure may be required to report on the financial statement impact of The New Law.

### Tax Accounting for The New Law

This section highlights certain of the potentially significant tax accounting implications of The New Law, including:

1. Unified income tax rate,
2. Unified tax deduction policies,
3. Tax holiday and other preferential tax treatments,
4. Grandfather provisions,
5. Anti-avoidance rules, including control foreign corporation ("CFC") and thin capitalization rules,
6. Withholding taxes,
7. Place of management as a residency determinant factor.



## Unified income tax rate

The New Law establishes a single unified 25% income tax rate for most companies irrespective of the percentage of foreign participation and geographic location. However, a qualified enterprise with small profits may enjoy a 20% preferential income tax rate and a qualified hi-tech enterprise a 15% preferential income tax rate. Again, such preferential income tax rate will apply to both foreign investment enterprises (“FIE”) as well as domestic enterprises.

**Tax Accounting Consideration:** The unified income tax rate may immediately impact on companies’ deferred tax assets and liabilities by changing the income tax rate applicable to temporary differences scheduled to be reversed in 2008 and later years. Beginning in 2008, the unified income tax rate may impact on companies’ reported effective tax rates. The effective tax rate for FIEs which are currently enjoying income tax exemption or income tax rate reduction may increase. On the other hand, the effective tax rate for most of the domestic enterprises may decrease.

## Unified tax deduction policies

Under current tax laws, there are limitations on the tax deduction amount for specific types of expenses. The New Law changes many of these limitations.

**Tax Accounting Consideration:** Changes to deduction limitations may impact on companies’ tax accounting for permanent book-tax differences. From January 1, 2008 onwards, these changes may impact on the effective tax rates of companies.

## Tax holiday and other preferential tax treatments

The New Law changes existing tax holidays and other preferential tax treatments (see related transitional rules under Grandfather Provisions).

**Tax Accounting Consideration:** Changes to tax holidays and preferential tax treatments may significantly impact on the tax accounting for permanent tax benefits (i.e. reduced income tax rates) of companies. These changes may immediately impact on the deferred tax assets and liabilities of companies as, under The New Law, a new tax rate may apply to temporary differences scheduled to be reversed in 2008 and later years. Beginning in 2008, the transition to the unified income tax rate may change the effective tax rates of companies.

## Grandfather provisions

The New Law provides grandfather provisions for existing FIEs currently enjoying tax holidays and preferential tax treatments to transition gradually to the new unified income tax rate.

**Tax Accounting Consideration:** The grandfather provisions may significantly complicate income tax accounting by gradually phasing-in the new unified income tax rate. During the phase-in period, companies may be subject to different income tax rates each year. Careful attention must be given to the income tax accounting for deferred tax assets and liabilities, as well as the current income tax provision, during the phase-in period. Companies may need to prepare detailed schedules to track anticipated reversals of temporary differences.

## Anti-avoidance rules, including CFC and thin capitalization rules

The New Law introduces anti-avoidance measures, including “reasonable commercial purpose” requirements, controlled foreign corporation rules and thin-capitalization rules. In addition, The New Law endorses cost-sharing arrangements and advance pricing agreements and emphasizes transfer pricing documentation. These changes may significantly change the tax benefits of companies under their existing legal and operating structures and transactions.

**Tax Accounting Consideration:** The introduction of anti-avoidance rules may impact on companies’ effective tax rates by making taxable certain tax positions the tax authorities consider to be “anti-avoidance.” These new rules also increase the uncertainty of tax reporting in China by introducing many new terms and concepts which are not yet well-defined in practice.

## Withholding taxes

The New Law promulgates withholding taxes at 20% on passive income.

**Tax Accounting Consideration:** This change may significantly impact on the effective tax rates of companies by subjecting certain previously tax-exempt transactions to withholding taxes.



## Place of management as a residency determinant factor

The New Law introduces the concept of “place of management” in determining tax residency. A company will be treated as a China tax resident if it is incorporated in China or its place of effective control and management is in China.

**Tax Accounting Consideration:** This change expands the definition of a resident company under The New Law, potentially subjecting previously non-resident companies to China’s income tax. This change may significantly change the effective tax rates of companies by making certain income of previously non-resident companies taxable.

## Other Considerations

### PRC GAAP Reform

Effective from 2007, companies listed on PRC stock exchanges must adopt new PRC GAAP standards, including enhanced standards on accounting for income taxes (which are similar to IFRS for income taxes, requiring accounting and disclosure of current and deferred tax expenses and balance sheet accounts). Careful consideration of the tax accounting implications of The New Law should be made when adopting the new PRC GAAP standards.

### US GAAP FIN 48

US GAAP Financial Accounting Standards Board Interpretation Number (FIN) 48, *Accounting for Uncertainty in Income Taxes*, dramatically changed accounting and reporting of income taxes for companies reporting financial statements under US GAAP, requiring substantial analysis of tax positions to determine consistent recognition and measurement of tax benefits claimed. The China income tax regime already presents considerable challenges in applying FIN 48 to tax positions claimed in China tax filings. As described above, The New Law changes many areas of existing tax law and introduces several significant new concepts, compounding the challenges in applying FIN 48 to income tax positions claimed in China tax filings.

**Tax accounting consideration:** The New Law introduces many new terms and concepts that must be evaluated and applied by both taxpayers and tax authorities. These new concepts may create additional uncertainties which will require further analysis under FIN 48. The IRR to be issued later this year may clarify some of these uncertainties.

## Sarbanes-Oxley (SOX) Section 404

For US registered public companies (and their consolidated subsidiaries), the assessment, evaluation and implementation of The New Law represents areas of potential internal control risk. Timely and careful consideration of the potential impact of The New Law is therefore essential.

## Action plan

With the establishment of The New Law, multinational companies with operations in China may consider taking the following actions:

- 1) Calculate the cumulative deferred tax adjustment to revalue deferred tax balances based on new income tax rates;
- 2) Re-assess FIN 48 conclusions, if applicable, related to recognition and measurement of tax positions;
- 3) Evaluate whether a change in reported valuation allowance is required;
- 4) Document, for internal controls purposes, any analysis and adjustments resulting from The New Law in the interim period; and
- 5) Consider whether it is appropriate to disclose the impact of The New Law in their interim reports;

The New Law represents a major change in China’s tax policy. Accordingly, all companies should review the impact of The New Law on existing tax planning, the potential new tax optimization strategies and the tax compliance and tax accounting implications. For subsidiaries of multinational companies in China, it is advisable to communicate such changes with corporate headquarters so that appropriate action may be taken early. Meanwhile, we will continue to monitor and communicate the developments related to The New Law and the IRR.



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For more information about the income tax accounting implications of The New Law, please contact the Ernst & Young Executives who handle your tax affairs or a member of Ernst & Young's Tax Accounting and Risk Advisory Services Team ("The Team") in China and Hong Kong. The Team blends our PRC tax experience with international US GAAP and IFRS financial reporting experience to deliver integrated tax accounting services and perspectives.

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