

Tax Alert

March 2007

China's New Corporate Income Tax Law – Changes and Recommendations

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Introduction

During the 5th Session of the 10th National People's Congress (NPC), which was concluded on March 16, 2007, the new Corporate Income Tax Law was approved and will become effective on January 1, 2008. This passage of the new Corporate Income Tax Law ends years of speculation as to how China will promulgate its income tax reform. The new tax law includes but is not limited to the much debated unified tax rate for both domestic enterprises and foreign invested enterprises (FIEs), changes to the current tax holiday and preferential tax treatments, and transitional provisions.

The new law aims to level the playing field to all companies in China and adopt more streamlined tax incentives that are in line with the country's economic policy. In addition, it clearly shows China's increasing attention on transfer pricing issues and provides the tax authorities with ample opportunities to make adjustments in the case the arm's length principle is not met. Combined with the newly introduced controlled-foreign corporation regime, anti-avoidance rules and new rules broadening the scope of entities that will be considered "tax resident" in China, the provisions included in the new law provide strong evidence that China is moving away from using tax policy as an instrument to attract foreign direct investment. In particular, the new anti-avoidance rules signal the intention of the tax authorities to

review currently implemented structures and to make adjustments as they consider necessary in the absence of a rational business purpose.

Key Elements of the New Corporate Income Tax Law

Unified 25% Corporate Tax Rate

The new law establishes a unified 25% corporate income tax rate. With an exception for qualified enterprises with small profits which retain a 20% preferential tax rate, both domestic companies and FIEs in China are generally subject to the 25% rate.

Under the current tax law, the 33% statutory income tax rate applies to domestic companies; while certain FIEs may enjoy a preferential tax rate of 24% or 15%. The unified tax rate significantly reduces domestic companies' nominal tax burdens, but for many FIEs currently under the preferential tax regime, their tax costs are expected to increase.

Unified Tax Deduction Policies

Currently domestic companies are subject to certain limitations on specific types of expenses. The new law eliminates those limitations, creating a more level field of competition between domestic enterprises and FIEs (for more details, see Table 1, Appendix).

Tax Holidays and other Incentives

The existing tax holidays and other prefer-

ential tax treatment will be streamlined in the following manner (for more details see Table 2, Appendix):

Expansion

Certain tax preferential treatment, such as high-tech enterprises located in National High-Tech Industrial Development Zones will be implemented nationwide. Revenue earned by qualified non-profit organizations is exempted as well. Enterprises that purchase special equipment that protects the environment, reduces the consumption of energy or water, raises manufacturing safety, etc. can claim a certain percentage of the investment in such equipment as a tax credit. Revenue derived from qualified environment protection, energy and water-saving projects and technology transfer can enjoy tax reduction or exemption. Furthermore, it is expected that the definition of high-tech enterprises will be updated.

Retention of Preferential Benefits

Certain preferential treatment will be retained for enterprises engaged in state-encouraged infrastructure facilities, whereby the regime allows exemption from income, a 15% tax rate or a 20% tax rate for small qualified enterprises. Similarly, preferential treatment is preserved for agriculture, forestry, stock breeding, and fishing industries. Enterprises that salvage and recycle resources to produce products that meet nationally mandated standards may continue to calculate rev-

enue on a reduced basis. In addition, the new law includes tax preferential treatments for venture capital enterprises.

Replacement

The new law introduces a super deduction for compensation paid to disabled workers and other employees who are encouraged to be employed by the government, replacing the current tax preferential treatment for employment-promoting companies.

Repeal

Tax preference provisions that are repealed under the new law include:

- The “two-year exemption followed by three-year half deduction” (2+3) tax holiday for the production FIEs;
- Extended three-year 50% rate reduction for technologically advanced FIEs;
- Extended 50% rate reduction for export-oriented FIEs;
- Preferential tax rates of 15% and 24%;
- Tax refund on reinvestment of after tax profits.

Transitional Rules

Existing enterprises that are enjoying certain preferential tax treatment will be covered by transitional rules. These are described in more detail in the following section.

Transitional Rules for FIEs

Notwithstanding the changes on preferential tax treatment, the new law provides transitional rules to the existing FIEs. For FIEs that are currently enjoying the preferential tax rate of 15% or 24%, their applicable tax rate will gradually be phased in to the new 25% tax rate during the 5-year transitional period. For example, the 15% tax rate will increase by 2% per year until it reaches 25% by the end of the 5-year transition period.

Entities that are currently benefiting under the fixed-term tax holiday regime will retain the remaining tax holiday until it is exhausted. If an existing company established by the announcement of the new law is currently entitled to a tax holi-

day but the tax holiday has not yet commenced due to accumulated losses, the tax holiday will be deemed to begin in the year the new law takes effect.

Transition relief will also be available to some qualified high-tech enterprises that are newly-established in specific areas, such as Shanghai Pudong New Area and the current five Special Economic Zones. They may be able to avail of the 2+3 tax holiday.

Withholding Taxes

The new law provides that withholding taxes of 20% will apply to passive income. Passive income is defined to include dividends, interest, royalties and capital gains. It is expected that further guidance on this subject will be provided in the detailed implementing regulations.

Anti-Avoidance and CFC Rules

The new law highlights that China will focus more on revenue raising effects. It endorses added enforcement efforts on business substance associated with transactions and corporate structures.

The new law incorporates anti-avoidance measures by introducing controlled foreign corporation rules. This effectively terminates income deferral strategies that have been enjoyed by certain domestic corporations and individuals who have had controlling interests in foreign corporations located in low tax jurisdictions. Under the new law, Chinese companies and individuals are required to recognize passive income that is unreasonably retained overseas as income subject to PRC income tax.

With respect to non-Chinese multinationals, the introduction of the anti-avoidance rules signals an aggressive approach by the tax authorities to review currently implemented tax structures. It also provides the tax authorities with ample opportunities to make adjustments as they consider necessary in the absence of a business purpose.

Transfer Pricing

The new law endorses cost sharing ar-

rangements, advanced pricing agreements and emphasizes transfer pricing documentation requirements. At the same time, it does not eliminate the possibility of tax consolidation of group companies in China. Looking forward, permanent establishment issues and transfer pricing enforcement will become a priority.

Details and further guidance on this subject can be expected in implementing regulations to be released shortly.

Concept of “Place of Management”

The new law introduces a concept of management in determining tax residency. A company will be recognized as a China tax resident if it is incorporated in China or its place of effective control and management is in China. This is a significant change from the current practice that is based solely on the place of incorporation.

Recommendations and Outlook

In light of the above Swiss multinational companies with operations in China should consider to review current transfer pricing policies and compliance efforts as well as to scrutinize supply chain and other planning ideas in order to ensure compliance with the new law and the anti-avoidance provisions. In addition, proactive planning should be considered so that China is in line with the company’s global tax policy.

Tax planning strategies should moreover be considered in dealing with passive income and permanent establishment issues.

Likewise, it is recommendable to capitalize on dividend reinvestment refund opportunities in 2007, since this may be the final year that a tax refund is available. A proactive tax planning is also suggested as regards the repatriation of dividends prior to any potential re-imposition of dividend withholding tax.

Finally, the new tax incentives should be evaluated and it should be considered how to best incorporate them into a potential new investment in China. ■

Appendix

Table 1: Comparison of Expense Deduction Policies

Tax Deduction Policy	Current Law	New Law
Salary	Domestic Companies have a cap of the deductible salary expenses while FIEs do not.	Reasonable salary expenses are deductible for both domestic companies and FIEs.
Donations	Donations are only deductible if made for public welfare or charity. For domestic companies, a deductible portion is limited; whereas FIEs are allowed a full deduction.	Both FIEs and domestic companies may deduct donations for public welfare or charity up to 12% of their taxable income.
Advertising Expenses	Deductions for domestic companies are limited. However, any excess may be carried forward. FIEs are allowed a full deduction.	Deductions for both domestic companies and FIEs are allowed if they are reasonable. Further details may be available in detailed implementing regulations to be released.

Table 2: Main Changes in Tax Holidays and Tax Incentives

Preferential Tax Treatments	Currently Available to	Changes under the New Law
15% Tax Rate	Companies domiciled in the Special Economic Zones and Shanghai Pudong New Area as well as production FIEs located in economic technological development zones.	Repealed, but a 5-year transitional period is applied to existing FIEs (see Transitional Rules for FIEs, page 2).
15% Tax Rate	Hi-tech companies in Hi-Tech Parks.	Applied nationwide. However, the definition of Hi-tech companies may change.
24% Tax Rate	Production FIEs in coastal economic open cities or other developmental areas.	Repealed, but a 5-year transitional period is applied to existing FIEs (see Transitional Rules for FIEs, page 2).
Two-year exemption followed by three-year half reduction (2+3 tax holiday)	Production FIEs	Repealed, but the remaining tax holiday is grandfathered (see Transitional Rules for FIEs, page 2).
50% rate reduction for an extended period of three years	Technologically-Advanced Enterprises	Repealed, but the rate reduction is grandfathered during the transitional period (see Transitional Rules for FIEs, page 2).
50% rate reduction	Export-Oriented FIEs	Repealed.
Reinvestment refund	Foreign Investors, Foreign Invested China Holding Companies	Repealed.
Refund of local portion of the corporate income tax (CIT) revenue or local income tax	Provincial level governments and municipalities directly under the central government have the right to grant the local income tax exemption or local income tax reduction to encouraged FIEs.	Repealed.

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Imprint

Tax Alert
 Electronic publication in English.

Designed and produced by
 Ernst & Young Ltd
 Tax and Corporate Communications &
 Marketing
 P.O. Box, 8022 Zurich

Subscriptions/address changes
www.ey.com/ch/newsletter