Shanghai
21F, South Tower
Shanghai Stock Exchange Bldg.
528 Pudong Road South
Shanghai 200120 P.R.China
Tel: (86 21) 6881 8100
Fax: (86 21) 6881 6880

Beijing
Units 902-903
Winland International Finance Centre
No.7 Finance Street, Xicheng District
Beijing 100034 P.R.China
Tel: (86 10) 6655 5050
Fax: (86 10) 6655 5060

上海
上海市浦东南路528号
上海证券大厦南塔21楼
邮政编码: 200120
电话: (86 21) 6881 8100
传真: (86 21) 6881 6880

北京
北京市西城区金融大街7号
英蓝国际金融中心9楼02-03单元
邮政编码: 100034
电话: (86 10) 6655 5050
传真: (86 10) 6655 5060

www.llinkslaw.com
master@llinkslaw.com

Llinks Corporate Finance Bulletin
August 2007

Positive Tax Implications of China's New Corporate Income Tax Law on Future Foreign Investment

By David Yu and Bernie Liu

With the introduction of the *Enterprise Income Tax Law of the People's Republic of China* (**the New Tax Law**), the preferential tax policies enjoyed by foreign-invested enterprises (**FIEs**) have been abolished, leveling the playing field between domestic enterprises and FIEs. While it appears that the tax burden on FIEs will increase, the law also has some positive implications for their businesses.

Background

On 16 March 2007, the New Tax Law was promulgated by the National People's Congress. When it goes into effect on 1 January 2008, the New Tax Law will supersede the *Income Tax Law for Foreign-Invested Enterprises and Foreign Enterprises* (issued on 9 April 1991) and the *Tentative Provisions for Enterprise Income Tax* (issued on 13 December 1993) (**the Current Tax Laws**).

Under the New Tax Law, with certain statutory exceptions, the income tax rates applicable to both domestic enterprises and FIEs in China are unified at 25%. The New Tax Law also increases and unifies the withholding income tax rate on revenues generated by foreign enterprises (**FEs**) from China and abolishes the current preferential tax policies for FIEs. It is apparent that the operation of FIEs in China will be adversely affected in the following major aspects:

- **Decrease in competitiveness:** Under the Current Tax Laws, domestic companies are generally subject to a 33% income tax rate, but most FIEs enjoy preferential tax rates from 15% to 24% together with tax holidays, which materially increases FIEs' competitiveness and investment returns. Under the New Tax Law, save for the transitional period for preferential tax treatment, domestic companies enjoy same income tax rate and preferential tax policies as those of FIEs and, accordingly, the competitiveness of FIEs under the preferential tax policies no longer exists;

如果您需要本出版物的中文本，请与下列人员联系：

韩东红: (86 21) 6881 8100 - 6609
Publication@llinkslaw.com

If you would like other Llinks publications, please contact:

Lily Han: (86 21) 6881 8100 - 6609
Publication@llinkslaw.com

Llinks Law Offices
www.llinkslaw.com

- **Increase in Tax Burden:** Under the Current Tax Laws, although the statutory rate of income tax applied to FIEs is 33%, the actual income tax rate is far below the statutory rate with the preferential tax treatment. Although the statutory rate of income tax has been adjusted down to 25%, due to limited application of preferential tax treatment under the New Tax Law, FIEs are likely to pay more income tax for their businesses in China.

- **Increasing Difficulty in Tax Avoidance:** Under the New Tax Law, a new definition – Resident Enterprises – is introduced, which includes domestic enterprises, FIEs, and FEs with their actual management and control in China. Resident Enterprises will pay income tax on income generated both inside and outside China. Furthermore, the New Tax Law prescribes a transfer pricing supervision mechanism, which may further increase FIEs' taxable revenues in China.

Despite these negative aspects, the New Tax Law also has certain positive implications for foreign investment:

Industries without preferential tax treatment

Under the Current Tax Laws, FIEs which are involved in the manufacturing industry, high or new-tech industry, or incorporated in certain special investment zones with preferential tax policies, generally enjoy a preferential income tax rate varying from 15% to 24%, together with tax holidays, tax reductions, re-investment refunds and local tax refunds. For other FIEs, such as real estate companies and holding companies incorporated outside special investment zones, the income tax rate applicable is 33%. The introduction of a unified 25% income tax rate under the New Tax Law will give foreign investors incentive to invest in industries that previously operated under the 33% rate, as the expected return on investment will be increased by the difference in applicable income tax rate.

The New Tax Law's benefits for foreign investment can be seen in the following two examples. In case of the real estate industry, the threshold for foreign investment has recently been raised very high after the promulgation of several rules restricting equity-debt ratio, borrowing capacity for foreign debts and the actual implementation of the land appreciation tax. These rules were intended to stabilize the real estate market by raising operating costs and the threshold to the market, which at the same time lower investment returns and affect the bona fide investor in China. The unified income tax rate under the New Tax Law will increase profit margins in this industry and, to some extent, offset the negative effects of those restrictive rules on the real estate market.

In the case of multinational companies, the New Tax Law provides a unified tax rate equivalent to those applicable in other competitive jurisdictions. Provided that the Chinese government can create a better investment environment, this tax rate will make China an attractive location for multinational investors to establish holding companies to manage their China investments and, at the same time, these multinational companies will be able to efficiently manage their investments in China and lower their management costs.

Due to the fast growth of China's economy, more and more foreign investors are preferring to acquire fully-developed projects in China, which is of time-efficiency. However, in case an FIE is incorporated by means of acquisition of a domestic enterprise, no tax holidays (i.e. a 3-year tax exemption and 2-year 50% reduction in income tax) apply. Therefore, the abolishment of preferential tax policies under the New Tax Law does not seem likely to materially affect foreign investors' M&A transactions. On the other hand, the New Tax Law can benefit M&A transactions, as the unified income tax will increase the value, competitiveness and profit expectation of domestic enterprises.

Transfer pricing arrangements

The New Tax Law introduces transfer pricing regulations and supervision mechanisms to prevent tax avoidance in Chapter 6 "Special Tax Adjustment" of the New Tax Law. In other jurisdictions, transfer pricing is a significant issue for multinational companies that engage in cross-border related-party transactions and is often cited as a major issue in tax audits as it can result in substantial income adjustments or tax assessments. The Current Tax Laws also give the tax bureau the authority to adjust contract prices if it concludes a contract price has no reasonable commercial basis. It is the first time that the People's Republic of China has officially raised the transfer pricing issue and prescribes a basic guideline for transfer pricing arrangements in China.

In practice, multinational companies generally reach transfer pricing arrangements with their group companies or other related parties in China, allowing FIEs to transfer profits without incurring income tax in China. There are no detailed guidelines for transfer pricing under the Current Tax Laws, making it likely that certain transfer pricing arrangements may be classified as tax evasion activities and such FIEs may accrue tax liabilities. Moreover, under the *Tax Collection Law of the People's Republic of China,* the tax bureau can demand under-paid income tax for a period of 10 years. This means that, from a tax payer's perspective, transfer pricing arrangements can be deemed as a contingent tax liability.

The New Tax Law sets forth principles clarifying the regulations on transfer pricing. The principles are as follows:

- advance pricing arrangements are permitted if authorized by the tax bureau;
- related-party transactions shall be fully disclosed to the tax bureau along with annual corporate tax returns; and
- taxable revenue or income can be adjusted if the business transactions are found to have no reasonable commercial basis.

The New Tax Law also sets forth general guidelines for transfer pricing, making it possible for multinationals to minimize their transfer pricing risks by adjusting their transfer pricing arrangements in accordance with the New Tax Law.

New tax incentive policies

The New Tax Law adopts a unified income tax rate of 25% for domestic enterprises and FIEs and abolishes the preferential tax policies under the Current Tax Laws. To ensure the smooth implementation of the New Tax Law, it allows a five year transitional period for FIEs that currently receive preferential tax treatment. For FIEs which have not started to enjoy their tax holiday, the transition policy will deem that their tax holiday commences on 1 January 2008. For FIEs with preferential tax rates, the New transition policy Law sets forth a principle that the unified income tax rate will be gradually phased in during the transitional period, which is to be further clarified by the State Council. Without detailed implementing rules, it is not clear how the preferential tax policy under the New Tax Law will be applied during the five year transitional period in a case where the preferential tax treatment provided under the New Tax Law is more beneficial to the taxpayer than the Current Tax Laws.

In addition, although the new law unifies the income tax rate over domestic enterprises and FIEs, it also introduces a new set of preferential tax policies intended to spur investment in state-encouraged industries, technologies, and fields, which are as follows:

- Income generated from the following projects may enjoy tax exemptions or tax reductions:
  - agriculture, forestry, grazing and fishery projects;
  - environmental protection projects or energy and water conservation projects;
  - basic infrastructure projects in compliance with the state policy; and
  - qualified technology transfer;
- Research and development costs for new products, new technologies, and new craftsmanship qualify as pre-tax income deductions;
- Income tax can be reduced for venture capital investments in industries encouraged by state industrial policies. Deductions will be calculated based on a percentage of the investment amount;
- Shorter tax depreciation periods can be adopted for advanced technology improvement;
- Taxable revenue generated from products manufactured using comprehensive resources pursuant to state industrial policies can be reduced; and
- Taxable revenue can be reduced for a percentage of expenditures on equipment for environmental protection, energy and water conservation, and production safety.

Although the New Tax Law does not provide any detailed rules implementing these policies, it is apparent that the preferential tax policy is focused on high-tech industries and industries encouraged by the state industry policies.

Income tax withholding arrangements

Under the Current Tax Laws, FEs that have not established any FIE in China are generally subject to withholding income tax at a rate of 20% on their China-generated income. During the implementation, this 20% withholding rate was adjusted down to 10% by the State Council and applies to dividend, profit, interest, royalties, capital gains, rental income, etc. The Current Tax Law does not, however, require FEs to pay withholding income tax on dividends generated from its permanent establishments in China.

The New Tax Law re-introduces a unified 20% income tax withholding rate and abolishes the tax exemption for dividends. These changes will materially affect the investment return previously enjoyed by foreign investors, especially for companies incorporated in tax havens such as the British Virgin Islands.

Positive Tax Implications of China's New Corporate Income Tax Law on Future Foreign Investment

Notwithstanding that the New Tax Law imposes a 20% withholding income tax on almost all income generated by FEs in China, proper cross-border tax planning can mitigate the adverse effects. It is expressly prescribed in the New Tax Law that in case of any inconsistency between the New Tax Law and bilateral tax treaties between China and other countries or areas, the bilateral tax treaties shall prevail. FEs may therefore wish to consider reducing the portion of withholding income tax by taking advantage of such treaties. For example, under the *Agreement Between the Government of the People's Republic of China and the Government of Barbados for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income,* the withholding income tax imposed on the income derived from the dividends or profits of a permanent establishment invested by a Barbados resident company shall not exceed 5%, creating an opportunity to minimize tax withholdings.

Although the New Tax Law leaves a lot questions which need to be further clarified and implemented by the State Council, it introduces a clear framework for income tax collection and a unified tax policy for Resident Enterprises reflecting that China's economic policy is integrating with international practice. It is expected that the New Tax Law will help establish a more transparent and level tax regime and a more competitive market. And it is advisable that multinational companies should review their current tax planning and policies and make adjustments accordingly in order to mitigate any adverse effects caused by the New Tax Law.

Contact Details

If you would like to know more information about the subjects covered in this publication, please feel free to contact the following people or your usual Llinks contact.

Shanghai	Beijing
David Yu Tel: (86 21) 6881 8100 - 6635 David.Yu@llinkslaw.com	**Wayne Chen** Tel: (86 10) 6655 5050 - 1022 Way.Chen@llinkslaw.com
Grant Chen Tel: (86 21) 6881 8100 - 6613 Grant.Chen@llinkslaw.com	

This article was first published in *Corporate Finance Review, A Specialist Supplement to Asialaw, Volume 3 Issue 3 July 2007*.