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China Update: New Enterprise Income Tax Law Promulgated

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In this Issue:

The long-awaited new *Enterprise Income Tax Law of the People's Republic of China* ("New EIT Law") was finally promulgated by the National People's Congress ("NPC") on March 16, 2007, and is scheduled to come into effect January 1, 2008. The New EIT Law will replace the two separate, existing laws on enterprise income tax ("EIT") that are applicable to domestically funded enterprises ("DEs") and foreign invested enterprises ("FIEs"), respectively.

As background, it is commonly understood that FIEs enjoy a more preferential tax treatment than DEs in the People's Republic of China ("PRC" or "China"). With China's accession to the WTO in 2001, there have been increasing calls to level the playing field of DEs and FIEs. Passage of the unified New EIT Law is an attempt to heed such calls and results in both DEs and FIEs being subject to taxation under the same law. The new EIT legislation also abolishes certain generally available tax incentives for FIEs, for example, the typical 2+3 tax holiday for simply being a production-oriented FIE. With the removal of special tax incentives for FIEs, such entities may face more competitive pressure from DEs.

Overall, the approach of the New EIT Law to FIEs, appears from a technical standpoint, to be similar to the approach for imposing EIT to FIEs under the current legislative regime. For example, the New EIT Law imposes restrictions, albeit to a lesser extent, on the deduction of various business expenses, adopts the tax-exempt treatment for intercompany dividend distributions, retains the consolidated tax filing for branches, and emphasizes transfer pricing issues. Therefore, foreign investors should not see a dramatic change from the existing EIT regime. However, the New EIT Law is not simply a collection of amendments to the existing EIT law applicable to FIEs, but rather contains eight chapters and 60 articles (compared to 30 articles under the existing EIT law) applicable to FIEs. There are several substantive rules to watch out for, some of which are highlighted below.

The State Council will issue more detailed implementation regulations, to take effect together with the New EIT Law on January 1, 2008. It is also envisaged that the Ministry of Finance and the State Administration of Taxation ("SAT") will further review and consolidate existing EIT rules, as well as issue a large number of new technical EIT rules in the coming years. The issuance of the New EIT Law is only the tip of the iceberg.

Resident Status and CFC Rules

The New EIT Law introduces the concept of tax resident status. An enterprise is considered to be resident for tax purposes if it is incorporated in China pursuant to PRC law or if it is incorporated pursuant to foreign law but maintains its actual management office in China. Therefore, if an enterprise maintains a nominal place of registration in a foreign jurisdiction but exercises actual management in China, the enterprise will be characterized as a resident enterprise, which is subject to EIT on its worldwide income.

At present, it is common practice for Chinese individuals or companies to establish an offshore company in a low-tax jurisdiction and then use the offshore company to reinvest in China (the so-called "round-trip investment"). One benefit of such an investment structure has been that the investee subsidiary in China is able to enjoy the preferential tax treatment applicable to an FIE. Dividends from the subsidiary could be parked offshore without being taxed in China so long as the offshore company did not make any actual distribution of the dividend proceeds to the ultimate controlling Chinese shareholders.

PRC legislators regard such round-trip investment structures as taking advantage of FIE tax incentives without bringing in actual foreign capital needed by China. To deter these types of investment structures, in addition to removing the preferential tax treatments available only to FIEs, the New EIT Law adopts a deemed profit distribution clause similar to the deemed dividend rules applicable to Subpart F income under the controlled foreign company rules under U.S. federal income tax law. According to the deemed profit or dividend distribution clause, which is included under the chapter on special tax adjustments (further discussed below), if an enterprise that is established in a low-tax jurisdiction and owned or controlled by a resident enterprise or Chinese resident individual has not made an actual distribution of profits - in effect, has retained its profits - or has otherwise reduced the distribution of such profits in the absence of a reasonable business need, the portion of profits allocable to the resident enterprise must be included in the current taxable income of the resident enterprise.

Reduced Standard Rate

The New EIT Law has adopted a standard EIT rate of 25%, reduced from the 33% rate currently applicable to both FIEs and DEs.

According to official statistics, the effective EIT rate currently applicable to FIEs is about 15%, on average, after taking into account various FIE tax incentives. As such, the new 25% EIT rate may increase the tax burden of many FIEs but should be beneficial for FIEs that did not qualify for relevant tax incentives under the existing law and are currently taxed under the standard 33% rate.

The standard withholding EIT rate applicable to the passive income of non-resident enterprises remains at 20%, subject to reduction or exemption in accordance with the rules of the State Council.

Tightened Tax Incentives and Grandfathering Treatment

Changes under the New EIT Law to the existing set of tax incentives have garnered the most attention in discussions regarding this new legislation.

Under the current regime, FIEs are able to enjoy various forms of tax incentives. Many of these incentives are location-based or have a low threshold for qualification. The New EIT Law changes the approach to the granting of tax incentives by limiting them, at least in principle, to encouraged industries and projects. Therefore, certain low threshold tax incentives available under the current rules have been eliminated—for example, the 2+3 tax holiday for production-oriented FIEs and the reduced 10% EIT rate for export-oriented FIEs. Also, the New EIT Law no longer provides for a tax refund to foreign investors for the purpose of reinvestment in China.

Nonetheless, the New EIT Law still provides for many tax incentives, as highlighted below:

i. A reduced 15% EIT rate applicable to high-tech enterprises wherever established. The specific qualifications for eligibility are to be clarified in the implementing regulations.

ii. A reduced 20% EIT rate applicable to small enterprises with negligible profits. The specific qualifications for eligibility are to be further clarified in the implementing regulations.

iii. An additional bonus deduction (of likely 50%) of the actual R&D expenses applicable to all enterprises.

iv. Accelerated depreciation of fixed assets affected by technological obsolescence.

v. A special reduction to the amount of taxable income for enterprises that utilize resources extensively in the manufacture of products in compliance with the national industrial policy.

vi. A tax reduction, or exemption, on income derived from engaging in agricultural, forestry, husbandry, or fishery projects, infrastructure projects, and environmental protection or energy or water conservation projects, or income derived from certain qualified technological transfers.

vii. A tax credit available to venture capital enterprises that invest in encouraged industries and to enterprises that purchase special equipment used for environmental protection, energy and water conservation, and safe production processes, etc.

The State Council is also authorized to grant special tax incentives to encourage development for the purpose of meeting certain economic and social needs or responding to unexpected public emergencies.

To ensure that the tax burden of FIEs is not substantially increased due to the adoption of the New EIT Law, a system of grandfathering is available to qualified FIEs so that they can continue to enjoy existing tax incentives during a five-year transition period beginning on January 1, 2008.

In principle, under the New EIT Law, only FIEs established as of the date of the Law's promulgation can be grandfathered, i.e., March 16, 2007 is the effective cutoff date to qualify for grandfathering. If a qualified FIE under existing law enjoys an EIT rate that is less than 25%, such rate will be gradually increased to 25% over the five-year grandfathering period. Additionally, a qualified FIE enjoying a tax holiday under existing law can continue to enjoy the benefit of such tax holiday until the date of expiration of the respective tax holiday. However, if the tax holiday has not yet begun as of January 1, 2008 because the FIE has not yet had its first profit-making year (the triggering event for the commencement of the tax holiday under the existing rules), under the New EIT Law the tax holiday period will automatically begin on January 1, 2008.

There appears to be one exception to the cutoff date rule for grandfathering treatment. According to the New EIT Law, high-tech enterprises newly established after March 16, 2007 in one of the special zones or in the Shanghai Pudong New Area are still able to enjoy transition-period treatment. Until implementation regulations are issued by the State Council, the application of the transition period procedure to such enterprises is unclear. This is one of the few location-based tax incentives retained in the new legislation. Another such location-based tax incentive seeks to encourage continued investment into the western region of China.

Heightened Anti-Tax Avoidance Rules

The most profound change that the New EIT Law will bring to tax practice in the PRC is covered in the chapter on special tax adjustments.

China has been making rapid progress in developing transfer pricing rules. The special tax adjustment chapter is, for the most part, an outgrowth of past transfer pricing practice. The cornerstone concept remains the arm's-length rule. Any related-party transaction not conducted on an arm's-length basis could be subject to a transfer pricing review and adjustment by the tax authority. However, due to the absence of significant penalties, existing transfer pricing rules do not have any real teeth. Under the New EIT Law, any tax increase resulting from an adjustment by the tax authority would be subject to late-payment interest in accordance with State Council rules. Currently, the late-payment charges on other outstanding tax payments are 0.05% per day, or about 18% per year.

In addition, the New EIT Law imposes a documentation obligation on taxpayers. It is expected that the tax authorities will soon issue detailed contemporaneous documentation rules. All investors should be aware of transfer pricing issues in their operations, in view of the upcoming documentation obligations and the ten-year retroactive application of the transfer pricing adjustment.

The good news about the special tax adjustment chapter is that it formally recognizes cost-sharing arrangements in connection with intangibles and services. Advance pricing arrangements ("APAs") are also codified allowing taxpayers the opportunity to take advantage of APAs to facilitate related-party transactions. The special tax adjustment chapter also incorporates a thin capitalization clause (no deduction is allowed for payment of interest to a related party where the debt equity ratio is beyond the allowable criteria) and a deemed profit distribution clause (discussed above) to further empower the tax authority in combating tax avoidance.

Finally, the special tax adjustment chapter contains a general anti-tax avoidance clause. Any transaction that lacks a reasonable business purpose and results in a decrease in taxable income is subject to adjustment by the tax authority. The tax authority would have the legal basis to challenge any transaction on the basis of tax avoidance. This raises significant concerns such as what the appropriate standards are to determine the lack of a reasonable business purpose and which authority should have the final decision-making power. It is particularly problematic in view of the uneven economic development and varying levels of sophistication of tax officials in different areas of China, as well as the lack of a well-developed process to facilitate the judicial review of actions of the tax authorities. The underlying issue is whether the tax authority should become a type of economic police that reviews every transaction to see if the business purpose criteria has been met. It will be a long-term challenge for the SAT to ensure consistent enforcement of the new general anti-tax avoidance rule. Taxpayers should bear this rule in mind when structuring tax effective transactions and operations.

Consolidated Tax Filing

According to the New EIT Law, a consolidated tax filing is not allowed for different enterprises or a company group, unless the State Council provides otherwise. Under existing rules, only certain DE company groups have been approved by the State Council to file consolidated tax returns. It remains to be seen whether any FIE company groups will be approved to file a consolidated tax return under the New EIT Law. A consolidated tax filing is only allowed for branches of a single resident enterprise, however losses generated by offshore operations cannot be used to offset the profits generated from the onshore operations. If a non-resident enterprise has two or more establishments in China, upon the approval of the relevant responsible tax authority, the non-resident enterprise may select the primary entity to file a consolidated tax return on behalf of all of the group's establishments in China.

In connection with the consolidated tax filing, the resident enterprise shall pay the EIT to the tax authority in the resident enterprise's place of registration (or place of management, as the case may be). This raises concerns that tax revenue will become concentrated in a few popular areas in which enterprises are willing to maintain their registration. China's fiscal authority may, at some point, need to reconsider the fiscal revenue distribution regime in order to ensure an appropriate distribution of revenue that more effectively matches the development of different areas. Otherwise, the New EIT Law may exacerbate tax competition among different areas.

Indirect Foreign Tax Credit

The New EIT Law provides resident enterprises receiving dividends from a controlled foreign subsidiary with an indirect foreign tax credit in respect of the foreign taxes paid by the subsidiary.