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New PRC Enterprise Income Tax Regime

by Christoph Hezel, Munich / Shanghai

On January 1, 2008, the new *Enterprise Income Tax Law* (“EIT Law”) of the People’s Republic of China (“PRC”) became effective. The EIT Law had already been promulgated by the 10th National People’s Congress on March 16, 2007, however left various issues open and unanswered. It was hoped by foreign investors as well as practitioners that further guidance as regards these open issues would be provided by the Detailed Implementing Rules (“DIR”) for the EIT Law which were finally approved by the State Council on December 6, 2007, after a lengthy process of discussions involving various government bodies, multinational companies, scholars, legal practitioners, and others concerned.

Increase of tax burden for foreign investors

Enterprises in the PRC, regardless whether they are foreign-invested enterprises (“FIEs”) or domestic enterprises, are now subject to a standardized general EIT rate of 25% (the general EIT rate under the old tax regime used to be 33%). However, whereas under the old tax regime FIEs could qualify for various kinds of tax incentives, such as tax holidays and preferential tax rates as low as 15%, most of these incentives are now no longer available under the new EIT regime. A particular strong impact on the general increase in the overall tax burden for foreign investors has the introduction of the 10% Withholding Income Tax (“WHT”) on dividends paid by FIEs to their overseas parent companies (Art. 91 DIR) (see below). Therefore, starting from 2008, the overall tax burden for foreign investors may be as high as 32.5% after including the WHT, which means a severe impact on many FIEs previously only facing a tax burden of for example 15%.

New incentive schemes

New/high technology enterprises ("NHTE")

Most likely the most important remaining incentive is the one for NHTE which enjoy a preferential tax rate of 15% compared with the new standard EIT rate of 25%. However, in order to qualify as a NHTE, all of the following conditions precedent would need to be fulfilled by the FIE applying for such status (Art. 93 DIR):

- Ownership of core IP rights
- Products/services fall under the prescribed scope of "New/High Technology Sectors Particularly Supported by the State" (reference should be made to the respective product/service catalogue to be released by the State Council)
- Special ratio of R&D expenses/total income has complied with
- Special ratio of new/high technology income/total revenue has complied with
- Special ratio of technical personnel/total number of employees has complied with

Although the term "core IP rights" has not been clearly defined by the DIR, it has been repeatedly stated by government officials during the law-drafting process that this would require the transfer of respective patents and other IP rights to the FIE. Given the fact that foreign investors are normally reluctant to transfer core proprietary IP rights to the PRC and rather tend to adopt a contract R&D model where the IP ownership stayed with the overseas company, it has to be anticipated that many FIEs previously enjoying the NHTE

status might not qualify anymore for such status under the new EIT regime.

On December 26, 2007, the State Council has released tax circular Guofa [2007] 40 granting additional incentives to NHTE fulfilling above requirements and located in the five special economic zones (i.e. Shenzhen, Zhuhai, Shantou, Xiamen and Hainan) as well as in the Shanghai Pudong New Area. Such incentives contain a two years tax holiday starting from the first income generating year followed by three years of 50% EIT rate deduction.

Other incentives

Other tax incentives available under the new tax regime include, among others:

- Preferential EIT rate of 20% for small scale enterprises
- 150% super-deductions allowed for R&D expenses incurred in the development of qualified new technology, new products and new processes
- EIT exemption or reduction available to income from various activities in the agricultural, forestry, husbandry and fishery sector
- Major public infrastructure projects, certain energy and water preservation activities and environmental protection activities may be subject to three years tax holiday followed by a three years 50% EIT reduction

Grandfathering rules

The new EIT Law provides for a transitional period during which tax incentives which were available for enterprises

under the old tax regime but are now eliminated are grandfathered for a maximum term of 5 years. Under the following scenarios grandfathering of "old" tax incentives will be available:

- Enterprises entitled to enjoy a reduced enterprise income tax rate of 15% or 24% under the old tax laws may continue to enjoy a reduced tax rate that, however, will be gradually increased during five years after the effectiveness of the EIT Law to the general tax rate of 25%
- Enterprises enjoying tax exemptions and reductions for a certain term (i.e. tax holidays and preferential tax rate under the "old" 2+3 rule) may continue to enjoy such preferential treatment until the respective term expires
- Enterprises which have not yet started their tax holidays available under the old tax laws due to the fact that they have not made any profits so far shall be deemed to commence their tax holidays from 2008.

Although the EIT Law left room for interpretation which FIEs may enjoy grandfathering rules, the DIR make clear that respective FIEs must have obtained their business license prior to March 16, 2007.

Tax circular Guofa [2007] 39 which was issued by the State Council on December 26, 2007, clarifies the question how the new EIT rate will be phased in for "old" FIEs. The following procedure will be adopted:

- FIEs subject to a EIT rate of 33% or 24% under the old regime will be subject to the new EIT rate of 25% starting from January 1, 2008

- FIEs previously subject to a preferential tax rate of 15% will be subject to an increase in EIT rate as follows: 18% (in 2008), 20% (in 2009), 22% (in 2010), 24% (in 2011), 25% (from 2012 onwards).

“Tax resident enterprise” concept

The EIT Law establishes a new concept of “tax resident enterprise”.

A tax resident enterprise refers to an enterprise which is either established under PRC laws or which is established under foreign laws but has its effective management in the PRC.

Since tax resident enterprises are subject to PRC EIT on their worldwide income, foreign investors will need to structure their management structure carefully to avoid unintended tax exposures in the PRC.

The DIR have now further defined the “place of effective management” as “the place where, in substance, the overall management and control of the production and business operation, employees, accounting, properties, etc. is located”. It appears that such broad definition leaves great space for tax authorities’ interpretation and discretion. It remains to be seen how the authorities will implement above concept in practice.

On the other hand, however, companies may need to explore whether the “tax resident enterprise” concept can be also used for tax planning purposes. According to Art. 26 (2) EIT Law, dividends between resident enterprises are tax exempt income.

Consequently, dividends paid to a foreign parent company, the effective management of which is located in the PRC, should be exempt from the 10% WHT.

WHT on dividends

Whereas under the old tax regime dividends paid by FIEs to overseas enjoyed a WHT exemption, such dividends (as also other PRC sourced passive income from e.g. royalties, interests, rentals, etc.) are now subject to 10% WHT. Foreign investors therefore might explore opportunities to benefit from tax treaties PRC has concluded with other jurisdictions which provide for a lower WHT rate (note: the Sino-German tax treaty also provides for a 10% WHT rate).

During the law making process there have been discussions as regards a potential WHT exemption on dividends paid by NHTE which however has not been realized by the DIR.

However the DIR provide for the possibility of WHT exemptions to be later approved by the State Council. Therefore, there might be still room for lobbying efforts by foreign investors in this regard.

New anti-avoidance rules

Similar to western jurisdictions, the EIT Law and DIR formally introduce anti-avoidance provisions empowering the tax authorities to adjust taxable income where business transactions are arranged without reasonable commercial substance (particularly between related parties) and are seemingly meant to avoid taxes.

In connection herewith, the EIT Law and DIR contain more de-

tailed disclosure requirements as regards related party transactions. Furthermore, prevention of tax avoidance through low tax rate countries has been introduced. Profits derived at such locations may be taxed in the PRC as deemed distribution. The EIT Law and DIR also provide for thin capitalization rules in form of disallowing excessive interest expenses.

Summary

For many years the PRC has been a location with comparably low tax rates for many foreign investors. Especially with (i) the cut-down of the general availability of tax-holidays and preferential EIT rates, (ii) the fixing of a standard EIT rate at 25% and (iii) the cancellation of the WHT exemption for dividends, foreign investors are now facing a more challenging environment under the new tax regime. Careful tax planning therefore becomes increasingly important to secure the profitability of the PRC operations.

The DIR are far from clarifying all open issues which are left by the EIT Law. It is expected that various future tax circulars will provide further guidance in this regard.

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