

Impact of New CIT Law on Foreign Investors

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Since January 1st, 2008, the long-awaited new Corporate Income Tax Law ("CIT Law") which unifies the CIT systems for the foreign invested enterprise and the domestic enterprise came into effect. In this article, we have summarized some of the important changes that may impact foreign investors doing business in China.

1. Concept of "Tax Resident Enterprises"

The new CIT law has introduced the concept of "tax resident" for the first time as for determining each enterprise's the tax liabilities in China. Where an enterprise qualifies as tax resident in China, all the income is subject to CIT in China while for a tax non resident, only those China sourced income is subject to CIT. The residency is determined under the CIT Law through the dual application of "place of incorporation" and the "place of effective management" tests. So for foreign companies which the core management team is mainly stationed in China, attention shall be given to avoid being regarded as the tax resident in China which shall lead to CIT exposures.

2. Tax Rate

The new standard CIT rate is 25%. A reduced rate of 20% applies to small and thin-profit companies. For qualified high/new technological enterprises, a concessionary rate of 15% applies. The withholding income tax on those passive income (e.g. dividends, interest, royalties, rentals, capital gains, etc.) to be received from China is still maintained at 10%. Since China has entered into a number of tax treaties that provide for a lower withholding tax rate for dividends, interest and royalties (e.g. Hong Kong, Singapore, Barbados and Mauritius treaties apply a 5% WHT on dividends, Hong Kong treaty applies a 7% WHT on interest and royalties), ownership restructuring may be appropriate for foreign investors.

3. Deduction of Expenses

The new CIT Law stipulates that an enterprise can deduct reasonable expenses that are actually incurred and are related to the generation of income. We have summarized below some of the major changes of the tax deductions.

(1) Reasonable salaries and wages actually incurred and related to the enterprise's operation can be fully deductible. The deduction limit on wages which used to be a big tax adjustments item for domestic enterprise is no longer existed.

(2) Employee education expenses are deductible subject to an annual cap at 2.5% of the total salaries and wages. The excess can be carried forward for deduction in the following tax years.

(3) The "business entertainment expenses" is deductible subject to the limit which is the 60% of total amount, and 5‰ of annual turnover, whichever is lower. This new provision signifies that only partial deduction is allowed.

(4) Advertising and promotion expenses actually incurred in a year can be tax deductible up to 15% of the turnover for that year. The non-deductible amount for a year can be carried forward for tax deduction in future years.

(5) Charitable Donations. The deduction scope and limit for the charitable donations are loosened. Donations up to 12% of an enterprise's net income can be deductible for tax purposes.

(6) Sponsorship Expenses. The CIT Law specifically disallows the deduction of sponsorship expenses.

(7) Interest expenses paid on bank loans can be tax deductible. However, those paid to non-financial institution lenders may only be deductible up to the normal interest rate offered by commercial banks.

(8) Management Fees. Management fees paid to related-parties are still not deductible.

(9) Deduction of Acquired Goodwill. The CIT Law disallows the internally generated goodwill for tax deduction. However, the implementation rule further stipulates that acquired goodwill can be deductible at the time when the company transfers its entire business or liquidates.

4. Tax Incentives

The new CIT Law abolishes most of the geography-related tax rate reductions and incentives offered to manufacturing and export FIEs, including:

- The "2+3" tax holidays (two years exemption and 3 years 50% reduction) for manufacturing FIEs
- 50% rate reduction for export FIEs
- 15% or 24% preferential income tax rate in specially designated economic zones and cities along the east coast
- The CIT credit on re-investment of the business profits derived in China
- Exemption of withholding income tax on the dividend distribution

The tax incentives under the new CIT law are mainly on the industry based and are formulated so as to pertain to the direction of the nation's economic development.

- A preferential tax rate of 15% is granted to the high and new technology enterprises encouraged and supported by the State. Tax benefits will also be extended to cover venture capital investments and investments for the purposes of environment protection, energy/water saving and production safety.
- The existing preferential tax policies on farming, forestry, animal husbandry, fishing industries and infrastructure are retained.
- State-encouraged high and new technology enterprises newly established in special economic zones and the Shanghai Pudong New Area can enjoy transitional benefits, however the preferential tax treatment available to "encouraged" enterprises investing in the Western region of China would remain in effect.
- "Income from environmental protection projects" and "income from technology transfer that meets certain criteria" will enjoy a tax exemption or reduction. These are new measures recently added to the draft law being presented to the National People's Congress.

5. Special Tax Adjustments

The new CIT Law contains a chapter entitled "Special Tax Adjustments" that deals with the special issues related to transfer pricing and anti-tax avoidance, which include the following provisions.

- General anti-avoidance provision for making adjustments to taxable revenue or taxable income where business transactions are regarded as arranged without reasonable commercial purpose.
- The CIT Law has introduced a new concept of Cost Sharing Arrangement ("CSA") allowing the participants to share the joint costs incurred for the research and development of intangibles and provision or receipt of services. The CSA shall be in line with arm's length principle.
- An annual related-party transactions report must be filed when the annual income tax return is filed with the tax authorities.
- Enterprises may enter into advance pricing agreements with the tax authorities.
- CFC rules intended to compel PRC shareholders to bring to tax in the current tax period their proportional interest in the undistributed profits of CFCs established in comparatively low-tax jurisdictions.
- Thin-capitalisation rules which apply to deny "excessive" interest expense deductions.
- The CIT Law introduces new interest levy for tax adjustments made by tax authorities for tax avoidance activities. The DIR clarifies that interest levy shall comprise of two parts: (a) financing charge for the delayed tax payment; and (b) an additional 5 percent penalty interest.

6. Transitional Arrangement

- The new CIT Law has provided grandfathering treatment to "Old FIEs", which are defined as those FIEs whose establishment has been approved and their registration has been completed on or before 16 March 2007.
- Enterprises which were previously entitled to a CIT rate of 15% shall be liable for 18% tax rate in 2008, 20% in 2009, 22% in 2010, 24% in 2011 and 25% in 2012. Enterprises previously qualifying for a tax rate of 24% shall be liable for a 25% tax rate in 2008.