

# China Outlook\*

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## China Releases Regulations to Implement its New Corporate Income Tax Law

Based on a December 11, 2007 Xinhua News Agency report, China's State Council (the Cabinet) released tax regulations to facilitate the enforcement of China's new Corporate Income Tax Law ("CIT Law"), which became effective on January 1, 2008. Based on the report, the regulations (entitled "Detailed Implementation Regulations" or "DIR") were officially promulgated by the Cabinet on December 6, 2007. During the news conference following the release of the DIR, Chinese government officials highlighted several salient features of the regulations. In the sections below, we have taken key points discussed by Chinese government officials and added our observations.

### Foreign Enterprises Could be Taxed Under CIT Law as "Tax Resident Enterprises"

In general, a Chinese "resident company" is subject to Chinese corporate income tax on its worldwide income (i.e., both China and foreign source income); while a "non-resident company" (i.e., foreign enterprise) is taxed only on China source income. For those foreign enterprises with establishments in China, only the foreign source income effectively connected to the Chinese establishment is taxed in China.

As an anti-tax avoidance measure, the DIR provides the authority to tax a foreign enterprise ("FE") as a resident

company or "tax resident enterprise", if the foreign enterprise has its effective management organization within China. The FE would then be subject to CIT on its worldwide income.

According to Chinese government officials, the DIR defines the "place of effective management" as the location where the effective "overall management and control" over the production and business operations, employees, accounting and properties of an enterprise is exercised.

### PwC Observations

Under this anti-tax avoidance provision, the use of a tax-haven entity to conduct Chinese business could potentially expose the tax-haven entity to China taxation on its worldwide income. In addition, even some non-tax haven foreign enterprises potentially could be affected by the "tax resident enterprise" rule. US investors are advised to evaluate their existing business models, assess their CIT tax exposure under this deemed "tax resident enterprise" rule of the DIR. Modification of existing operating structures may be required to mitigate this exposure. The exposure may be intensified to the extent that the government has not issued specific guidance as to how to weight some key factors in determining the existence of "overall management and control" in China.

China Outlook is a newsletter designed to provide you with insights into the China marketplace and how that can impact your business. We hope that this newsletter will be informative for you and would appreciate any feedback you would care to offer.

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## The DIR Broadens Taxable Income Inclusions and Expense Deductions

Under the new China CIT and DIR, gross income includes all forms of receipts, such as cash, deposits, receivables, promissory notes, forgiveness of debt, receipt of tangible/intangible property or services received as consideration.

Deductibility of reasonable expenditures or losses is allowed to the extent the expenditures are related to the generation of income and connected with business operations. According to Chinese government officials, the DIR provides limits on the deductibility of certain types of expenditures, including:

- Employee training expenditures
- Business entertainment expense
- Advertising and business promotion costs
- Charitable donations

Under the new tax law system, the DIR removes the deductible limit imposed on actual wage expenditures, allowing for reasonable salaries and wages actually incurred by an enterprise to be fully deductible. The DIR also allows tax deductions for employee benefit programs and union dues incurred by the employers.

## PwC Observations

The DIR has relaxed several tax deduction limitations imposed on domestic-owned enterprises. Under the legacy tax system, domestic-owned and foreign-owned enterprises were subject to different rules in computing their taxable income, with domestic enterprises subject to more stringent rules than its foreign-owned counterpart.

The new CIT Law is intended to level the playing field and to provide one set of rules to all Chinese enterprises in computing taxable income. For foreign owned enterprises, the DIR may provide less favorable results than under the legacy system. For example, the DIR limits the annual advertising deduction by all Chinese enterprises; whereas under the legacy tax system, foreign owned enterprises enjoyed a more favorable treatment.

The inclusion of all forms of receipts as gross income under the DIR is expected to have a greater CIT impact on domestic-owned enterprises as they are more likely to engage in barter trade transactions or other non-monetary transactions. However, foreign-owned enterprises should also examine the potential impact of this rule to avoid unexpected tax consequences.

## New Tax Incentives for Environmental Protection or Public Infrastructure Projects

Based on Article 27 of the CIT Law, certain qualified income derived from basic public infrastructure projects or environmental protection and energy/water conservation projects may qualify for tax holiday incentives. The tax holiday period consists of three tax-free years, followed by another three years of up to a 50% reduction in the statutory CIT rate. This six-year tax holiday period starts from the first income-generating year.

The Investment Tax Credit is available to encourage the purchase of certain qualified equipment used for environmental protection, energy/water conservation, or production safety. A maximum of 10% of the total qualified purchase costs may be used to reduce a taxpayer's current-year tax liabilities. The unapplied excess credit can be carried forwarded for five years.

## PwC Observations

Through the promulgation of its CIT Law and the DIR, the Chinese government is attempting to reshape its current manufacturing-based economy into an innovation driven one. It is the Chinese government's intent to build its future industry on enterprises with core competencies in innovative technology, environmental protection and energy conservation by offering incentives in these areas. Foreign enterprises possessing the related core technologies could leverage these opportunities by reformulating or modifying their China investment strategies.

## Encouraging the Development of Advanced Technology

The DIR provides tax incentives to resident enterprises for the transfer of qualified technology, allowing either a tax exemption (up to the first 5 million RMB of profit) or a 50% tax rate reduction. The DIR also provide bonus tax deductions for an extra 50% of certain qualified research and development ("R&D") expenditures incurred.

To encourage the investment in small/medium sized technology enterprises, the DIR provides tax credits to certain qualified investment enterprises. An investment enterprise that invests in a qualified start-up company may be able to take 70% of qualified investment capital as a tax credit against their future income tax liability. To enjoy the investment tax credit, the qualified investment enterprise not only has to invest in a qualified technology company, it must also hold this investment for a period of not less than two years. The investment tax credit will be granted in the tax year when the investment enterprise fulfills its two year holding period requirement.

## PwC Observations

The DIR provides tax credit benefits to venture capital (“VC”) investors to encourage the investment in certain designated small/medium sized non-publicly traded “high or new technology enterprises” (“HNTE’s”). As the incentives only apply to investment in companies endorsed and encouraged by the Chinese government, the definition of those qualified start-up companies will need further clarification. It is expected that the Chinese government will release additional guidelines to clarify which investments may qualify for this type of investment tax credit.

## Reduced Withholding Tax Rate for Non-resident Enterprises

The DIR reduces the 20% statutory withholding tax rate in the new CIT Law to 10%, which is in line with the previous withholding tax rate applicable to most passive income except for dividends. This 10% reduced rate is imposed on foreign enterprises’ China source income, not effectively connected to its Chinese establishments. In addition, the DIR provides an exemption on interest withholding on certain qualified loans issued by foreign governments to the Chinese government or loans with favorable terms that are issued by international financial organizations to the Chinese government or resident enterprises.

## PwC Observations

Under the legacy tax system, profit repatriation by foreign owned enterprises was exempt from China’s dividend withholding tax, whereas the DIR imposes a 10% Chinese withholding tax on China source passive income, including dividends, interest, royalties, rent, and gain on transfer of properties. US investors should monitor the timing of

repatriation of China profit to optimize their global tax efficiency.

## Tightening Requirements for Technology Enterprise Tax Incentives

Under Article 28 of the CIT Law, certain qualified HNTE’s may enjoy a reduced 15% corporate income tax rate. The DIR provides that the relevant ministries of the state council can provide more specific requirements for enterprises qualify for this tax benefit. Several parameters may be used to qualify a HNTE for this tax incentive, such as:

- Whether the enterprise possesses core technology and owns intellectual property rights in China.
- Whether the products or services of the enterprise are specifically listed under the “government endorsed and encouraged HNTE industry catalog” issued by the central government.
- Whether the enterprise satisfies certain operating ratio requirements.

## PwC Observations

The DIR only addresses the general conditions for a technology enterprise to enjoy the 15% reduced tax rate benefit. It is expected that specific requirements will be released by the relevant ministry offices of the state council. It is also expected that the requirements will be relatively stringent and only a very limited number of technology companies that possess innovative core technologies will be able to qualify for this reduced rate benefit.

Many foreign investment enterprises (“FIE’s”) that previously qualified for HNTE status and enjoyed a 15% tax rate under the legacy tax regime may not qualify for the HNTE tax incentive requirements under the DIR. Technology-based companies may wish to re-align their global intellectual property (“IP”) ownership strategy and evaluate the possible benefits of transferring IP ownership to Chinese affiliates, balanced against IP protection considerations.



## China Issues Transition Rules for Existing Tax Incentives

In a report by the Xinhua News Agency on December 29, 2007, China's State Council issued Circular No. 39 ("the Notice") providing details for Chinese enterprises that previously enjoyed preferential tax incentives. Based on the Xinhua report, starting January 1, 2008, FIE's that previously enjoyed a preferential rate of 15% will have five years to gradually phase in the statutory corporate income tax rate of 25%. This transition period also applies to Chinese domestic owned enterprises.

Based on the Notice, those foreign enterprises that previously qualified for five year tax holiday benefits will

retain their tax holiday concessions for a period of not more than five years. While for those enterprises entitled to the 10-year tax holiday period will also retain their concessions for a period of not more than ten years. For enterprises that qualify for tax holiday benefits but have not made any profit, 2008 will be deemed their first profitable year.

### PwC Observations

Depending on the nature of the operation, an enterprise may find preferential tax rates provided under the new CIT more favorable than the transitional tax rates mentioned

above. The Notice disallows double benefits and requires an enterprise that may qualify for preferential tax treatment under both the transitional rules and the new CIT law to make an irrevocable election on the applicable method in computing its tax liability.

The release of the DIR was not intended to provide all the answers or guidance for the implementation of China's new CIT Law. In fact, many of the details and procedures will be released in the form of circulars or tax notices. We expect a large volume of circulars will be issued in the near future.

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### The Chinese Business Network

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