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China's Top Legislature Approves Landmark Property and Tax Laws

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1. China's Top Legislature Approves Landmark Property and Tax Laws

China's parliament, the National People's Congress (NPC), concluded its annual session on March 16 with the adoption of landmark property and corporate income tax laws, as reported by the Xinhua News Agency.

Based on the report, the new property law protects ownership of property regardless of whether it is owned by government or private owners. The new corporate income tax law unifies corporate taxation under a single system that provides equal treatment to Chinese domestic and foreign owned enterprises.

The property law demonstrates China's spirit of reform since it protects the Chinese "socialist" market economy while granting equal protection to public and private property owners, said Wang Shengming, Vice Chairman of the Commission of Legislative Affairs of the NPC Standing Committee.

Chinese Finance Minister Reports to the National People's Congress

Finance Minister Jin Renqing recently delivered the Explanation on the Draft Enterprise Income Tax Law of the People's Republic of China ("New Tax Law") at the Fifth Session of the Tenth National People's Congress. Based on a transcript provided by the Xinhua News Agency (BEIJING, March 8; www.Chinaview.cn), we have provided the following summary of this new tax legislation.

Background of the Tax Legislation

Currently, China's domestic and foreign-funded enterprises are governed under two different tax codes. Foreign-funded enterprises are taxed under the 1991 income tax law passed by the NPC, while Chinese domestic enterprises are taxed by the 1993 income tax law promulgated by the China State Council. These two tax systems provide different tax treatment for the taxing of enterprise profit.

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The tax law applicable to foreign-funded enterprises was originally designed to attract foreign investment for the development of China's economy. Ever since the late 1970's when China initiated economic reform and started opening up its economy, foreign-funded enterprises have enjoyed favorable income tax treatment compared to their domestic counterparts. This approach proved effective in attracting foreign investment as Chinese government statistics illustrate. By the end of 2006, the Chinese government had approved the establishment of about 594,000 foreign-funded enterprises, with collective investment funds of about \$691.9 billion. In 2006, the Chinese government collected tax revenue of \$795 billion from these foreign-funded enterprises, which accounts for 21.12% of total national tax revenue.

In recent years, China has experienced dramatic social and economic changes with China's accession to the WTO and the opening up of its domestic market to foreign-funded enterprises. Chinese domestic enterprises have gradually integrated into the world economy and face fierce global competition, but the current unfavorable tax treatment hampers their competitiveness. Without a unified enterprise income tax system, fair market competition would be obstructed.

Due to its deficiencies, the current dual enterprise income tax system can no longer support China's continued economic growth, reported Minister Jin. These deficiencies include:

1. Under China's current dual income tax system, foreign-funded enterprises enjoy preferential tax treatment over domestic enterprises. Based on a national survey, the average enterprise income tax rate

imposed on foreign-funded and domestic-funded enterprise profits are 15% and 25%, respectively.

2. Current tax loopholes could distort behavior, leading to the loss of tax revenue. For instance, to obtain tax benefits available to foreign-funded enterprises, many Chinese investors disguise their domestic investments by transferring the investment funds through offshore entities, thereby taking advantage of the tax incentives available to foreign-funded enterprises.
3. The existing enterprise income tax system is outdated as China has experienced substantial economic and social evolution during the past ten years. For example, many of the provisions were put in place to attract foreign investment in China manufacturing and export operations whereas China's current needs are to upgrade certain industries.

The proposal to unify enterprise income tax regime responds to these challenges. The enactment of this law is expected to improve China's economic structure and enhance fair competition.

Main Provisions of the New Tax Law

The New Tax Law is highlighted by "four unifications"

1. Unification of income tax law applicable to both domestic and foreign-funded enterprises.
2. Unification and appropriate reduction of enterprise income tax rates.
3. Unification and standardization of deductions.

4. Unification of preferential income tax policies by granting industry and region based incentives.

The following summarizes the key provisions of the New Tax Law:

Tax Rate: Income tax is currently levied on domestic and foreign-funded enterprises at the same rate of 33%. However, foreign-funded enterprises in some special regions are levied tax at a preferential rate of 24% or 15%. Domestic low-profit enterprises are levied at special rates of 27% and 18%.

Table 1

	Average Tax Rate
China	25%
China's neighbors (18 countries and regions)	26.7%
Other countries and regions (159 globally)	28.6%

The New Tax Law sets the new tax rate at 25% (Article 4, Paragraph 1). It is intended to ease the tax burden on domestic enterprises while raising the tax burden on foreign-funded enterprises as little as possible.

Tax Preferences

Main Provisions

Although the New Tax Law abolishes most manufacturing and export driven tax incentives, it preserves or expands the policy for other tax incentives.

Finance Minister Jin Renqing presents the preferential income tax policies and incentives into five categories:

1. A reduced preferential rate of 20% is provided to eligible small low-profit enterprises and a preferential rate of 15% is provided to certain qualified hi-tech enterprises (Article 28 of the New Enterprise Tax Law). Preferential treatment is also available to venture investment enterprises (Article 31) and enterprises investing in environmental protection, energy and water conservation, work safety devices, among others. (Article 34).
2. Preferential tax policy incentives are retained that would encourage the investment in agriculture, forestry, animal husbandry, fisheries and infrastructure construction (Article 27).
3. Direct tax rate reduction benefits or exemptions are repealed and substituted with a preferential policy for labor service enterprises, welfare enterprises and enterprises making comprehensive use of resources (Articles 30 and 33).
4. Transitional preferential tax treatment will be preserved for newly-established hi-tech enterprises receiving priority support from the State and that are located in special economic zones with the approval of the State Council (e.g., the Pudong New Area in Shanghai). Tax preferential policies for industries or regions encouraged by the State will continue to be implemented (Article 57).
5. Certain production-based tax incentives are cancelled or replaced. For example, the regular tax reduction and exemption for production-orientated foreign-funded enterprises as well as the 50% tax reduction for export-oriented foreign-funded enterprises is abolished. Instead, tax incentives are provided to qualified enterprises that generate “income from environmental protection

projects” and/or “income from eligible technology transfer” (Article 27). Tax relief provisions are also added to minimize loss due to natural disasters (Chapter IV).

Transitional Measures

The New Tax Law will increase the income tax burden on some existing enterprises. To ease the impact, transitional measures are provided for existing enterprises that enjoy preferential treatment under the current law. With these transitional measures, existing enterprises entitled to incentive tax rates of 15% or 24% will see their tax rate gradually increase during the first five years after the New Tax Law becomes effective. Those enterprises that are currently entitled to tax reduction and exemption benefits may continue to enjoy their remaining incentives through the period specified by the current income tax laws. However, for enterprises that have not made profits and therefore have not claimed their tax reduction and exemption benefits, the period for enjoying these benefits shall be calculated from the year the New Tax Law becomes effective.

Given the policy considerations and complexity of these transitional measures, the New Tax Law provides the State Council with the authority to develop measures for the implementation of transitional incentives (Article 57).

Statutory Definition of Taxable Income

Taxable income is the base amount used to calculate the income tax payable by an enterprise. Under the New Tax Law, taxable income of an enterprise is the amount remaining from its gross income in a tax year after excluded income, exempt income, deductions, and loss carry-forward are deducted (Article 5).

Income

The New Tax Law defines gross income as “an enterprise’s monetary and non-monetary income from various sources” (Article 6). Excluded income is defined as income from fiscal funds such as fiscal appropriations, administrative charges subject to fiscal administration and government funds (Article 7). Exempt income is defined as income from interest on treasury bonds and from equity investments such as dividends and bonus between eligible resident enterprises (Article 26).

Deductions

Under the existing dual enterprise income tax system, domestic enterprises and foreign-funded enterprises are subject to different tax limitations for deductible expenses. For example, domestic enterprises are limited in the salaries and wages they are allowed to deduct, while foreign-funded enterprises are allowed to deduct actual salaries and wages. The New Tax Law unifies the deductibility of various expenditures incurred by enterprises, prescribes the standards for deducting expenditures for public welfare donations (Article 9) and defines the scope of nondeductible expenditures (Article 10). It also unifies provisions for the deduction of expenditures related to an enterprise’s fixed assets, intangibles, long-term prepaid expenses, and investment assets and inventory (Articles 11 to 16).



Landmark Property and Tax Laws Approved (continued)

Tax Collection

Supplementary provisions of the New Tax Law standardize the administration of enterprise income tax, simplify the tax payment procedures and reduce the cost for both taxpayers and tax administrators.

Methods of tax payment

The current practice is for domestic enterprises to pay tax locally as independent economic accounting entities while foreign-funded enterprises are required to consolidate their China profit and pay tax at the location of their head offices. To unify and simplify tax payment, the New Tax Law provides that a resident enterprise establishing operational entities without legal person status shall calculate and pay enterprise income tax on a consolidated basis (Article 50).

Special Tax Adjustment

To curtail tax avoidance and in accordance with international practice, the New Tax Law provides rules for

preventing tax avoidance through transfer pricing among associated enterprises. It also provides general anti-avoidance rules and articles against thin capitalization and avoidance through tax havens. Moreover, it sets forth provisions for assessment procedures and collection of interest from settling tax in arrears as provided for by the State Council (Chapter VI).

PwC Observations

With the passage of the New Tax Law, China enters into a new era of economic development and ushers in what China hopes will be a brand new tax environment. While this law presents some clear guidance as to the direction of China's tax development, we anticipate more detailed rules and regulations based on this New Tax Law will be forthcoming in the months ahead.

The Chinese Business Network

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Specializing in both US and China tax laws, we can provide a wide range of services for companies with interest in operating in China. Whether a company needs assistance with expanding their current China operations or with their first ever venture into the country, we have the expertise and knowledge to provide a comprehensive approach to their China operations. We are well versed in China's income tax laws, value added tax and customs issues, as well as foreign exchange regulations.

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