

tax notes

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The Enterprise Income Tax Law of China, and the implementation regulations

The new Enterprise Income Tax Law (EIT) was enacted on 16 March, 2007, to unify the income tax levied on domestic and foreign enterprises. On 6th December 2007 guidance was issued in the form of Implementation Rules. These rules bring clarity, but there are still uncertainties. What is certain is that this new law will fundamentally change the way business is done in Mainland China.

Executive Summary

A summary of some of the important new EIT Regulations and implementation guide lines issued follows:

- A "resident enterprise" is defined as an enterprise either established under the law of China or effectively managed in China.
- The corporate income tax rate is set at 25 percent, a reduction from 33 percent for Chinese companies. A 20 percent tax rate is introduced for small-scale enterprises earning only a small profit.
- Losses are only available for carry forward for 5 years.
- Taxes are eliminated on qualified dividends paid between resident enterprises.
- A 10 percent withholding tax is provided for on interest, dividends, rent, royalties, and other passive income derived by a non-resident enterprise from China.
- Limitations are provided for on the deduction of certain expenses, in particular entertainment expenses and advertising expenses. In addition, management fees paid between enterprises are disallowed.

- The deduction or amortisation of purchased goodwill is now disallowed.
- A reduced 15 percent tax rate is introduced for high and new technology enterprises. Tax exemptions are granted, or a 50 percent reduction in tax rate is allowed, for qualifying investments in the agricultural, forestry, animal husbandry, and fishery industries. A three-year tax exemption is provided for, and a three-year 50 percent reduction in the tax rates is allowed, for qualifying investments in infrastructure facilities industries, environmental protection projects, and energy and water saving projects.
- Tax exemptions are granted and reductions allowed for qualified technology transfers.
- A 150 percent tax deduction is allowed for qualified R&D expenses, and also a 200 percent tax deduction for wages paid to disabled workers.
- Venture capital enterprises are now entitled to a 70 percent extra deduction of the cost of investment in small and medium size new and high technology enterprises, for a duration of at least two years.
- Transfer pricing rules are confirmed, although the exact detail is still pending.
- Controlled foreign corporation rules have been introduced, again further detail is pending.
- Thin capitalisation rules have been introduced, again further detail is pending.
- A general anti-avoidance rule has been introduced.

A description and analysis of important provisions of the new EIT Regulations follows.



Resident enterprise

An enterprise is considered to be a "resident enterprise" if it is established under Chinese law or, if not established under Chinese law, it has its place of effective management in China. Such enterprises established under Chinese laws and administrative regulations are broadly defined, including business enterprises, public institutions, social groups, and other organisations that are established in China and receive income.

"Effective management" in China is considered to exist if the organisation that exercises management and control over production and business operations, personnel, finance and accounting, and properties is located in China. Companies should use caution when performing business functions within China to avoid inadvertently becoming treated as China tax resident.

A resident enterprise is generally subject to EIT at 25 percent. Small-scale enterprises earning small profits will be liable for EIT at a reduced rate of 20 percent.

Losses will only be available for carry forward for 5 years.

Non-resident enterprise carrying on business in China

A non-resident enterprise is liable for Chinese income tax on its income derived from China. If a non-resident enterprise has an establishment or place of business in China, the enterprise is subject to China tax on its income from China, and overseas income that is effectively connected to the establishment or the place of business in China. For all profits derived from an effectively-connected establishment, a non-resident enterprise is subject to the regular 25 percent tax rate.

The term "establishment" in the EIT Regulations covers a broader range of activities than does the term "permanent establishment" in tax treaties. An establishment includes, "the place of provision of services" and the "business agent." Multinational companies should structure transactions under treaty protection as China tax treaties have a narrower definition of "permanent establishment" than does "establishment" as defined in the EIT Law and the EIT Regulations.

Withholding tax for Non-resident enterprises

The EIT Regulations have implemented withholding taxes at 10 percent on income such as dividends, interest, rent, royalties etc.

Previously, dividends paid by FIEs to foreign shareholders were exempt from withholding tax. With the imposition of a 10% withholding tax rate and mandatory transfer pricing documentation requirement, companies may need to reconsider the holding and operating structure for China. But beware - two important provisions of the new law remain to be clarified. These are the effect of general

anti-avoidance provisions and the reorganisation provisions, as detailed below.

Deduction of expenses

In computing taxable income, the EIT Law allows an enterprise to deduct reasonable expenses actually incurred in relation to income. The EIT Regulations clarify the limitations on the deduction of certain expenses. Among those, the major expense items and their limitations are as follows.

Expense item	Deduction limitation	Comments
Employee welfare	14 percent of total salary	No carry forward
Union fee contribution	2 percent of total salary	No carry forward
Workers education	2.5 percent of total salary	Carry forward possible
Business entertainment	60 percent of such actual expense up to 0.5 percent of business revenue	No carry forward
Advertising	15 percent of revenue	Carry forward possible
Charitable contribution	12 percent of profit before tax	No carry forward
Management Fees	No deduction	Service fees are deductible
Sponsorship Expenses	No deduction	Non-advertising and not related to business activities

Amortisation of intangible and purchased goodwill

Intangible property generally can be amortised over a 10-year period using a straight line method. For acquired intangibles, if the useful life is provided in the applicable laws and regulations or the agreement, that useful life can be used as an amortisation period. The payment for purchased goodwill, however, can only be deducted at the time of either the transfer or liquidation of the enterprise.

The goodwill as a result of an asset purchase by a foreign invested enterprise can currently be amortised for 10 years. The new rule disallows such amortisation and, therefore, increases the amount of taxable income associated with acquiring a business. It should be noted that the new EIT Regulations do not provide detailed rules for the allocation of the purchase price.

Reorganisations

The new EIT Regulations state that, unless otherwise stipulated by regulations of the finance and tax departments of the State Council, gains or losses on the transfer of assets should be recognised at the time of the transaction in an enterprise reorganisation. Furthermore, the tax basis of the assets should be determined based on the transaction price.

Due to the absence of any specific reliefs in the new EIT Regulations, companies may wish to defer such reorganisations until further clarification has been issued.

Chinese Company Investment

Subject to certain exceptions, if a resident enterprise directly invests in another resident enterprise, any dividends received by the investing resident enterprise from the invested enterprise will be exempt from income tax. However the deemed Chinese resident company will be subject to EIT at 25 percent on the gain on disposal of its Chinese subsidiary, rather than the lower withholding tax that applies to non-resident enterprises. When structuring a group of companies with activities in China, companies will need to carefully consider the structure and exit strategies.

An enterprise is allowed to credit foreign income tax paid on foreign-source income against the EIT liability of the enterprise, including (1) income derived outside China by a resident enterprise; and (2) income derived outside China by a non-resident enterprise that is effectively connected with an establishment or place of business of the non-resident enterprise in China.

Creditable tax for a resident enterprise includes both foreign income tax paid by the enterprise and the underlying foreign income tax paid by qualifying foreign enterprises in connection with dividends received by the resident enterprise. In order to qualify for the indirect tax credit for the underlying foreign income tax paid by a foreign enterprise, a resident enterprise must directly or indirectly own at least 20 percent equity in the foreign enterprise.

A foreign enterprise is considered to be a CFC if (i) each of resident enterprises or resident individuals directly or indirectly owns 10 percent or more of a foreign enterprise's voting rights and those resident enterprises and resident individuals directly or indirectly own an aggregate total of 50 percent or more of the stock of the foreign enterprise; or (ii) although not satisfying (i), resident enterprises control the foreign enterprise via equity, financing, operations, or purchase and sales relationship. Under the new EIT Regulations, a resident enterprise shareholder must include its share of undistributed CFC profits in its gross income if the actual tax rate in the CFC's jurisdiction is less than 12.5 percent and the CFC fails to distribute profits without reasonable business reasons.

Investment Incentives

The new EIT law provides various tax incentives to both FIEs and domestic enterprises:

High-New Technology Enterprises ("HNTE")

A preferential income tax rate of 15% is applied to HNTE. The HNTE shall possess core proprietary intellectual properties and should satisfy the following conditions:

- a. recognised as within the scope of High-New Technology supported by the Chinese Government;
- b. annual Research and Development ("R&D") expenses shall not be less than a prescribed percentage of the enterprise's annual turnover;
- c. income derived from High-New Technology products or services shall not be less than a prescribed percentage of the enterprise's total income;
- d. the total number of R&D personnel shall not be less than a prescribed percentage of total employees of the enterprise; and
- e. any other conditions specified in High-New Technology Enterprise Management Rules.

Venture Capital Enterprise ("VCE")

A VCE is eligible to use a certain percentage of total investment to offset taxable income. A VCE shall invest in the equity of an unlisted small / medium sized HNTE for a period of more than 2 years. 70% of its investment can be used to offset taxable income for the year upon reaching the 2 years' ownership. The excess credit can be carried forward to the following years.

Encouraged Business

Exemption and reduction of tax is applied to income derived from the following projects:

- a. agriculture, forestry, animal husbandry, fishing industries;
- b. infrastructure projects;
- c. environmental protection, energy and water savings projects; and
- d. technology transfers under certain conditions.

Super-deduction on certain expenses

The new EIT law provides for a 150% deduction on R&D costs and 200% deduction for disabled employees' wages.

Recycling business

An enterprise engaged in recycling business, i.e. use of a prescribed raw materials to generate taxable income, can enjoy a 10% deduction on its total income in calculating its taxable income.

Special deduction on qualifying expenditures

Special equipment purchased by an enterprises for environmental protection, energy and water saving, manufacturing safety etc can be eligible for income tax credit for the year in which the equipment is purchased and used. The tax credit is calculated based on 10% of the purchase price of such equipment. The excess credit can be carried forward to the next 5 years. Equipment disposed of or leased out within 5 years will have the credit clawed back.

Accelerated depreciation

Fixed assets generally are depreciated using a straight line method over the life of assets. The minimum recovery periods are: 20 years for buildings; 10 years for trains, ships, aircraft, machinery, and production equipment; five years for appliances, tools, and furniture related to production and business operations; four years for the means of transportation other than trains, ships, and aircrafts; and three years for electronic equipment. An enterprise may shorten the recovery period or adopt an accelerated depreciation method for the fixed assets that (i) need to be replaced quickly due to development of technology; or (ii) are operated in a strong vibration or corrosion environment. If an enterprise adopts a short recovery period, such recovery period can be 60 percent of the normal recovery period stated above. For accelerated depreciation, the double declining balance depreciation method or the sum of the years digits method can be adopted.

Transfer Pricing

Chinese transfer pricing rules cover not only cross-border transactions but also related party transactions in China. Related parties are broadly defined and include direct and direct-control relations in ownership, funding, operations, supplies, sales, and other economic interests. The New EIT Regulations list various transfer pricing methods as reasonable methods. The EIT Law and the new EIT Regulations provide for the availability of advanced transfer pricing arrangements.

Further implementation rules on transfer pricing are likely to be issued. It is clear that transfer pricing documentation is mandatory and has to be contemporaneous, so companies need to be reviewing their operations now.

Thin Capitalisation

The EIT Law provides that if the ratio of related party debt received by an enterprise to its equity exceeds a given standard, the interest expense on the portion of related party loan exceeding the permitted debt-to-equity ratio cannot be deducted when computing taxable income. The new EIT Regulations define "related party debt" as financing obtained from a related party that is required to pay interest and return principal.

The new EIT Regulations do not give specific standards regarding the debt-to-equity ratio; instead, the EIT Regulations authorise the Ministry of Finance and the State Administration of Taxation to provide such standards.

Transition Period

The EIT Law provides certain reliefs during the transition period that apply to enterprises that were established prior to 16 March 2007:

- if enjoying reduced tax rates under the current laws and regulations, the tax rate will be gradually increased to coincide with the new tax rate within five years starting from 2008. For an FIE being taxed in 2007 at 15%, the rate will increase in 2008 to 18%, and by 2% each subsequent year until 2012, when it will increase to the maximum of 25%.
- if enjoying tax holidays for a fixed period under current laws and regulations, such enterprises can continue the tax holiday. However, if an enterprise has not started the tax holiday due to a lack of profits, 2008 will be deemed to be the first profit-making year.

The new EIT Regulations clarify that the above grandfathering relief applies to enterprises that completed business registration prior to 16 March 2007.

The tax concessions will be grandfathered over 5 years and losses will only be allowed to be carried forward for 5 years. Companies need to carefully plan their operations in Mainland China to take advantage of the concessions and any available losses.



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