

China's enterprise income tax law rewritten

By Luis Batalha, principal and Abraham Gang Sun, consultant

28 May 2008

The new PRC Enterprise Income Tax Law (**EIT**) and the Implementation Regulations (**Regulation**) took effect on 1 January 2008. This article summarises the main aspects of the new EIT laws.

Unified EIT regime & uniform tax rate

- unified the two separate income tax regimes, one for domestic enterprises (**DEs**), and another for foreign investment enterprises (**FIEs**) and foreign enterprises (**FEs**), into a single regime.
- a general rate of tax of 25% will be applied to all enterprises (resident and non-resident alike). In addition, non-resident enterprises will be subject to withholding tax at the rate of 20%.

New concepts of resident and Non-resident enterprises

- categorised taxpayers either as resident enterprises or non-resident enterprises.
 - resident enterprises are those established under PRC's laws or under another country's law, but their effective management is in China.
 - notably, the tax liability of FEs is significantly affected by the "effective management" test. That is, once an FEs is found to be a resident enterprise under the test, the FE will be liable to withholding tax at the rate of 20% on dividends, interests and royalties, paid by the FE to a non-resident of China

- the effective management of an enterprise refers to an institution that conducts comprehensive and substantial administration and control over production and business, personnel, finance and assets of the enterprise.
- non-resident enterprises are those enterprises set up under another country's laws and their place of effective management is outside China, but which:
 - have established an establishment or place of business in China; or
 - have not established an establishment or place of business in China, but derive income from sources in China.

Sourcing rules

- resident enterprises pay income tax on their income derived from China and abroad.
- however, non-resident enterprises are liable to income tax only if income is derived in China:
 - non-resident enterprises with an establishment or place of business in China will pay income tax at the 25% general rate on income derived from China through the establishment or place of business, or on income derived outside China but actually connected to the establishment or place of business; or
 - non-resident enterprises with/without an establishment or place of business in China are subject to withholding tax at the 20% rate on income derived from China by the enterprise even if the income has no actual connection with the establishment or place of business.
 - “establishment”, in broad terms, refers to establishments and places in China engaged in production and business operations. Notably, the appointment of a business agent in China to store and deliver goods will constitute an establishment.

Transfer pricing

- retains arm's length principle as mechanism to address related party dealings;
- sanctions Advance Pricing Agreements (**APAs**);
- allows Cost Sharing Arrangements (**CSAs**) covering joint development of intangible assets and provision of labour services;

- includes anti-avoidance rules, mainly including:
 - empowering tax authorities to make adjustments through reasonable means where an enterprise engages in non-arm's length dealings;
 - CSAs based on principle of matching costs with expected benefits;
 - submitting related party transaction reports;
 - imposing penalty interest on transfer pricing adjustments and interest at the standard RMB loan interest rate plus an additional 5%.

Exemptions

Exemptions are available under the new EIT laws. Some highlighted exemptions are as following:

- interest earned on State treasury bonds;
- certain interest income such as interest income on preferential loans made by international financial organisations to the Chinese Government and tax resident enterprises;
- returns, such as dividends, derived by a non-resident enterprise with an establishment or place of business in China from its equity investment in a resident enterprise if the dividends have an actual connection with the establishment or place of business;
- certain qualifying dividends derived by a tax resident enterprise, such as dividends from direct investment in other tax resident enterprises;
- income derived by a tax resident enterprise from the transfer of technology.

Tax incentives

- 20% tax rate applies to qualifying small-scale enterprises with a 'small profit' or certain high-tech enterprise.
- 15% tax rate applies to new high-tech enterprises.

In addition, a reduced tax rate or exemption applies to enterprises engaged in:

- agriculture, forestry and animal-husbandry, fishery projects;
- key public infrastructure projects;
- environmental protection, energy and water saving conservation projects;
- investment in qualified non-listed medium and small-sized high and new-technology enterprises.

Transitional rules

- due to the revocation of previous tax incentive systems, certain FIEs are entitled to these revoked tax incentives for a 5 year transition period.
- enterprises approved to be established prior to 16 March 2007 will qualify for the transition rules.

General anti-avoidance rules

- tax authorities are empowered to make reasonable adjustments where an enterprise implements an arrangement with no reasonable commercial purpose to reduce its taxable income
- profits of a non-Chinese enterprise will be taxable if:
 - the effective tax rate of the enterprise is lower than 50% of the general rate; and
 - the enterprise is controlled by a resident enterprise of China and/or individuals; and
 - the enterprise does not make any profit distributions or made unreasonable profit distributions to resident enterprises or individuals.
- thin capitalisation rule - interest will not be deductible if the ratio of an enterprise's related debt financing and equity financing exceeds a specified standard.