New Chinese Corporation Tax Regime: Detailed Implementation Rules for the new Corporate Income Tax Law and their impact on Foreign Invested Companies and High Tech Enterprises

As reinforcement to the Corporate Income Tax Law ("CIT Law") promulgated by the People's National Congress on the 16 March 2007, the PRC State Council promulgated the Detailed Implementation Rules on CIT Law ("DIRs") on 6 December 2007. The DIRs were implemented on 1 January 2008 and all domestic enterprises and foreign invested enterprises ("FIEs") in the PRC are subject to it.

The DIRs provide a basic legal framework for the corporate income tax ("CIT") regime. They provide for a more flexible policy to be adopted in future, when combined with circulars and notices which will deal with additional details stipulated by the PRC State Administration of Taxation ("SAT") and other relevant Chinese authorities.

Dividends

The new DIRs provide for a 10% withholding income tax charge ("WIT"), which applies to dividends that are distributed to non-resident enterprises outside of the PRC. This is distinct from the previous CIT regime for foreign invested and foreign-registered enterprises, under which such companies were fully exempt from WIT. It is important to note that the dividends paid by new high tech enterprises ("HTEs") in the PRC to their foreign parent companies are also subject to the 10% WIT charge.

Dividends paid from one Chinese tax resident corporation to another, which satisfy the following two tests, are exempt from CIT:

- Direct investment - one Chinese resident corporation directly holds the equity of another Chinese resident corporation; and
- Shares publicly listed in the PRC to which the dividend relates have been held for 12 months or more.

Other incomes derived in China

Other income derived from within the PRC by foreign companies, such as interest and royalties, remain subject to a 10% WIT charge (not, as was feared, an increased 20% WIT), subject to any applicable tax treaties.

Applicable income tax rate

The current 15% geographic incentive rate ("GEI"[1]) will increase progressively to 18%, 20%, 22%, 24% and 25% between 2008 and 2012. Although this was not stipulated in the DIRs, the relevant PRC state

[1] The GEI was originally granted to certain enterprises registered in defined areas of China, including special economic areas, economically and technologically advanced areas, and the Pudong new area.

authorities have now confirmed it. A specific exception has been made for non-manufacturing enterprises located in Pudong, which will immediately become subject to 25% GEI in 2008, without the benefit of the five year transmission period.

Reinvestment by foreign shareholders in China

In January 2008, the CIT Law and DIRs jointly abolished the 40%-100% refund on tax paid for dividend reinvestment in the PRC.

Tax residency

The test for PRC tax residency for FIEs mainly revolves around the definition of “effective management” (loosely defined as day-to-day management rather than strategic decision making). The non-Chinese companies with:

- manufacturing and business operations in the PRC;
- personnel management in the PRC;
- control over finance operations in the PRC; and/or
- properties in the PRC,

may be deemed as having their effective management centre in the PRC.

Companies likely to be affected by this change, such as Hong Kong based trading companies, which are managed by multinational companies in China, would be wise to pay close attention to the tax residency issue.

Permanent establishment

There is no guidance in the DIRs on the minimum time period required to qualify for permanent establishment (“PE”). This concept is instead subject to the relevant provisions in any applicable tax treaty. The “Business Agent” concept adopted in the DIRs provides for an agent engaged in manufacturing and other business activities for it’s FIE principals within the PRC, to be considered as a PE of the foreign principal in China. This new rule may encourage changes to be made to the present supply chain management of some foreign companies present in the PRC, such as those operating under the toll/contract manufacturing models in China (where foreign companies temporarily export materials to China and enlist a Chinese processing company to further process the materials before collecting back the processed goods.

Transfer pricing

The DIRs emphasize the “arm’s length” principle for transfer pricing transactions. Further information on this topic and its general requirements has been drafted but has not yet been issued. It is expected that circulars will be promulgated in due course in order to define what documentation will be required for the annual income tax filing with Chinese tax authorities.

FIEs in China can pre-empt the actions of the Chinese tax authorities by preparing the documents required for the transfer pricing process, or alternatively they can wait until some specific circulars are issued in this respect.

The DIRs do not provide further details on advanced price arrangements for transfer pricing transactions.

Cost sharing

The DIRs provide for relationships arising under a cost sharing agreement ("CSA"), such as services shared amongst several companies or intellectual property ("IP") jointly developed by several companies. A CSA allows for the service fees or royalties to be defined as expenses without attracting liability to CIT. In order to create a valid CSA, the terms of the CSA shall be drafted on an arm's length basis. The relevant supporting documents must be filed with the Chinese tax authority.

A CSA relationship may provide a company with a significant tax saving and may even help to relieve the problem that many FIEs in China face, namely an inability to extract cash from China.

Thin capitalization

Related party loans, such as back-to-back loans (including domestic affiliated loans or shareholder guaranteed loans), are subject to thin capitalization rules under the newly released DIRs. However, these rules do not provide any further guidance on whether the retained earnings are considered to be part of the total equity value (i.e. whether the value of the retained earnings will be included in the calculation basis for the ratio between debt and equity), nor what the exact definition of related parties is under the new CIT Law.

Domestic loans borrowed from local banks may not be subject to the above thin capitalization rules, but the interest expenses shall be in compliance with the applicable loan rate prevailing in the banking market at that time.

General anti-avoidance rules

The general anti-avoidance rules ("GAAR") apply when the main purpose of a business activity is to reduce, avoid or defer a tax liability payable in China. GAAR requires a legal and reasonable purpose for commercial activities that are independent of tax goals. This new regime will impact on virtually all tax planning in China. Documentary evidence and a reasoned explanation of the commercial reasons for a foreign operation to be based in China will become a crucial topic for FIEs. Detailed implementation and interpretation guidance for the GAAR has not yet been issued.

One of the measures included in the GAAR, is the ability to charge penalty interest. Daily interest will accrue on additional tax liabilities that arise as a result of the aforementioned transfer pricing issue, thin capitalization issue or breach of GAAR, at a rate of RMB basic lending rate plus 5%. The interest penalty is not deductible before calculating the taxable profit.

Statute of limitations

The DIRs provide that the Chinese tax authorities have the right to pursue and adjust an income tax liability for 10 years where a transfer pricing or GAAR issue arises. The period of 3 to 5 years will remain applicable in all other instances. There is no limitation for matters involving tax evasion in China.

Tax incentives

The most high profile element of the regime created by the CIT Law and the DIRs, is that of tax incentives to be provided to certain limited companies as follows:

- Three years tax exemption followed by three years of 50% tax reduction for infrastructure, environmental protection and water or energy saving projects in China;
- 10% tax credit for all equipment acquired for environmental protection and/or safety;
- Exemptions and tax liability reductions for certain agricultural businesses.

As stipulated by the CIT Law, qualifying companies are subject to a reduced CIT rate of 15%. The official criteria for qualification as a HTE with "core and independent" IP ownership, has not yet been published.

According to the CIT Law and the DIRs, research and development expenses can be deducted prior to calculation of taxable profit. The details on qualifying costs and/or activities that will qualify for this deduction have yet to be clarified but are likely to be defined in future circulars or notices issued by the PRC.

Company restructurings

The current tax-free concession for 100% owned group reorganisations of FIEs, may be changed and reissued in a later circular of the SAT, so as to remove this tax exemption. The DIRs do not provide further clarification of this issue.

Going forward

Many details remain to be clarified and specified in further circulars and notices to be promulgated by the PRC SAT and other state authorities. We will continue to monitor the developments and will provide up-to-date comments as the regime evolves.