Impact of the New Enterprise Income Tax Law on Foreign Investment in China

Scott Guan
Partner
Phone(Dir): (86-21)6235 1185
E-mail: scott.guan@jadefountain.com

Steven Huang
Partner
Phone(Dir): (86-21)6235 1300
E-mail: steven.huang@jadefountain.com

The new PRC Enterprise Income Tax Law ("EIT Law"), which was passed on March 16, 2007 and became effective on January 1, 2008, consolidates two separate enterprise income tax ("EIT") regimes for domestic-invested enterprises ("DEs") and foreign-invested enterprises ("FIEs") and represents a fundamental change in China's tax policy towards foreign investment. Its implementation rules and numerous circulars were subsequently issued, setting forth details of definitions, interpretations and specific applications of various provisions of the EIT Law. This brief will discuss some of the important impacts of the EIT Law and its detailed implementations rules and circulars on foreign investors with respect to the planning and structuring of their investment in China, whether through traditional green-field foreign direct investments or mergers and acquisitions.

1. <u>Removal of Tax Incentives for FIEs</u>

Under the previous EIT system, the standard EIT rate for both DEs and FIEs was 33%. However, qualified production FIEs with operation period of at least 10 years could enjoy two-year tax exemption and 50% reduction for the next three years commencing from the first profit-making year. In addition, for FIEs located in specific geographic locations, some further tax holidays were given by reducing the applicable EIT base rate to 15% or 24%. The EIT Law reduces the unified standard EIT rate from 33% to 25% and abolishes, except in special circumstances provided in the EIT Law, all the tax holidays conferred to FIEs as mentioned above. For FIEs established before March 16, 2007, which enjoyed a favorable EIT rate of less than 25% under the previous EIT system, a five-year transitional period is given by the EIT Law, during which, their EIT rates will gradually increase to 25%.

2. Incentives under the EIT Law

Although the New EIT Law abolishes most incentives for FIEs, it still provides some incentives to both DEs and FIEs in certain encouraged sectors such as high and new technology, venture capital, environmental protection, energy conservation, production safety, agriculture and infrastructure development. Tax holidays for enterprises located in China's under-developed western regions will continue to exist under the EIT Law. With the elimination of general tax holidays for FIEs, foreign investors now need to more carefully evaluate their investment opportunities and can consider adding new elements such as high and new technology or energy saving measures into their investment to try to qualify for tax incentives under the EIT Law.

3. Taxation of Non-Resident Enterprises

The EIT Law introduces a new "tax resident enterprise (TRE)" concept. A foreign investor whose effective management body is located in China is regarded as a TRE, which will be subject to Chinese EIT for its worldwide income. To avoid being taxed for its worldwide income, foreign investors shall be more careful on their TRE status under the EIT Law, as under the previous EIT system, companies registered in foreign jurisdictions, no matter where their management bodies were located, were only taxed on their PRC-sourced income.

Chinese tax authorities are also strengthening scrutiny on PRC-sourced income received by non-resident foreign companies. In a couple recent decisions made by two local tax authorities in China, both involving equity transaction of a non-resident foreign enterprise with operational subsidiary in China, the incomes realized from such offshore equity transfer were deemed as PRC-sourced income and a 10% income tax was imposed on the capital gain. Although these are only two separate decisions made by local tax authorities, foreign investors are advised to pay more attention on PRC tax implications in planning offshore indirect transactions involving China based assets or business.

4. Withholding Tax and Tax Treaties

Withholding tax on dividends paid by FIEs to foreign investors was specifically exempted under the previous EIT system. Now, such dividends are subject to a 10% withholding tax, with the exception to those dividends paid to qualified foreign investors incorporated in certain jurisdictions such as Hong Kong, Singapore, Mauritius and Barbados, which have bi-lateral tax treaties with China on reduced withholding tax rates. For example, dividends paid to a Hong Kong parent company which has 25% or more shareholding in a FIE is subject to a reduced withholding tax rate of 5%. Such jurisdictions may be used as intermediary holding locations by foreign investors for their investment in China. However, foreign investors shall also note that according to a recent new tax circular if the existence of such intermediary holding structure is deemed by Chinese tax authorities as being for the only purpose of obtaining tax treaty benefits, Chinese tax authorities still have the right to adjust the applicable withholding tax rate.

SHANGHAI OFFICE
31st Floor, Tower B, Far East International Plaza, 317 Xian Xia Road
Shanghai 200051, P.R.China
Tel: (86-21) 6235 1488 Fax: (86-21) 6235 1477
Website: www.jadefountain.com