



IMPLEMENTATION REGULATIONS FOR THE NEW ENTERPRISE INCOME TAX LAW OF CHINA

On March 16, 2007, China passed the new Enterprise Income Tax Law (the “EIT Law”), which will come into effect on January 1, 2008. The EIT Law will unify the two existing corporate income tax systems, one of which is currently applicable to foreign invested enterprises (“FIE”) and the other of which is applicable to domestic enterprises. The EIT Law authorizes the State Council to issue regulations to provide detailed implementation rules. On November 28, 2007, the Detailed Rules for the Implementations of Enterprise Income Tax Law (the “New EIT Regulations”) was approved in principle by the State Council. On December 11, 2007, the long-awaited New EIT Regulations were finally released. The New EIT Regulations clarify some provisions of the EIT Law; however, many uncertainties still remain. The New EIT Regulations authorize the finance and tax authorities within the State Council to issue detailed rules for many areas that were left open in the regulations. It is expected that the Ministry of Finance and the State Administration of Taxation will issue separate circulars concerning those areas.

The EIT Law and the New EIT Regulations made the following major changes and clarifications:

- Defined “resident enterprise” as an enterprise either established under the law of China or effectively managed in China.
- Reduced the regular income tax rate from 33 percent to 25 percent.
- Introduced a 20 percent tax rate for small-scale enterprises earning small profit.
- Eliminated taxes on qualified dividends paid between resident enterprises.
- Provided for a 10 percent withholding tax on interest, dividends, rent, royalties, and other income derived by a nonresident enterprise from China that is not connected with the establishment of the enterprise in China.
- Provided for limitations on the deduction of certain expenses such as welfare expenses, worker education expenses, entertainment expenses, advertising expenses, and donations.
- Disallowed the management fees paid between enterprises.

- Disallowed current deduction or amortization of purchased goodwill.
- Allowed foreign tax credit for the taxes paid by direct or indirect 20 percent owned foreign enterprises.
- Introduced a reduced 15 percent tax rate for high and new technology enterprises.
- Granted tax exemptions or a 50 percent reduction in tax rate for qualifying investments in the agricultural, forestry, animal husbandry, and fishery industries.
- Provided for a three-year tax exemption and three-year 50 percent reduction in the tax rates for qualifying investments in infrastructure facilities industries, environmental protection projects, and energy and water saving projects.
- Granted tax exemptions and reductions for qualified technology transfers.
- Allowed a 150 percent tax deduction for qualified R&D expenses and a 200 percent tax deduction for wages paid to disabled workers.
- Entitled venture capital enterprises to a 70 percent extra deduction of cost of investment in small and medium size new and high technology enterprises for a duration of at least two years.
- Allowed for a tax credit equal to 10 percent of purchase price for qualifying environmental protection equipment, water saving equipment, and safe production equipment used by the purchaser.
- Confirmed transfer pricing rules.
- Introduced controlled foreign corporation rules.
- Introduced thin capitalization rules.

Below is a description and analysis of important provisions of the New EIT Regulations.

RESIDENT ENTERPRISE

An enterprise is considered to be a “resident enterprise” if it is established under Chinese law or, although not established under Chinese law, 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 organizations that are established in China and receive income.

“Effective management” in China is thought to exist if the

organization that effectively exercises management and control over production and business operations, personnel, finance and accounting, and properties is located in China. The New EIT Regulations did not offer clear guidance regarding the specific factors that determine management and control, which leaves ample room for interpreting these terms to the tax authorities. It appears from the broad definition of effective management that a nonresident board and board meetings outside China may not be sufficient for a classification of an offshore entity as a nonresident enterprise for China tax purposes.

A resident enterprise is subject to Chinese tax on its worldwide income. If a foreign company is classified as a Chinese resident enterprise for Chinese tax purposes, it may not be taxed on the dividend received from its Chinese subsidiary subject to certain conditions. Yet the deemed Chinese resident company will be subject to EIT at 25 percent on the gain on disposal of its Chinese subsidiary, not the lower withholding tax that applies to nonresident enterprises.

A resident enterprise is generally subject to EIT at 25 percent. Small-scale enterprises earning small profit will be liable for EIT at a reduced rate of 20 percent. In order to qualify for such a small-scale enterprise, a manufacturing enterprise must have taxable income of not more than RMB300,000, employees of not more than 100, and total assets of not more than RMB 30 million; a nonmanufacturing enterprise must have taxable income of not more than RMB300,000, employees of not more than 80, and total assets of not more than RMB 10 million.

NONRESIDENT ENTERPRISE CARRYING ON BUSINESS IN CHINA

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

The term “establishment” in the New EIT Regulations cov-

ers a broader range of activities than does the “permanent establishment” as provided in tax treaties. An establishment includes, *inter alia*, “the place of provision of services” and the “business agent.” The New EIT Regulations define “business agent” as any entity or individual carrying on production or business activities in China on behalf of a nonresident enterprise, including often concluding contracts on behalf of the nonresident enterprise and/or storing and delivering the goods of the nonresident enterprise. According to those provisions, if “the place of provision of services” is in China, a foreign company will be subject to Chinese income taxes from the day services begin in China.

An agency relationship is another situation in which foreign principal can be exposed to Chinese tax. Currently, agency relationship exists in various business models such as contract processing and warehousing arrangements. Even though similar provisions exist in the current tax regulations, the Chinese tax authorities have, in practice, refrained from strictly enforcing the rules and imposing tax on the foreign principal in these types of arrangements. It is hard to say whether the EIT Law and the New EIT Regulations will alter this practice. Nevertheless, multinational companies should structure transactions under a treaty protection as China tax treaties have a narrower definition of “permanent establishment” than does “establishment” as defined in the EIT Law and the New EIT Regulations.

WITHHOLDING TAX FOR NONRESIDENT ENTERPRISES

According to the EIT Law, a nonresident enterprise is subject to a 20 percent withholding tax on income derived from China, but not effectively connected with an establishment or place of business in China. Such income includes dividends, interest, rent, royalties, gains on transfers of property, and other income. Yet the EIT Law authorizes the State Council to reduce or exempt the withholding tax by issuing regulations, and the New EIT Regulations have reduced the withholding tax to 10 percent. Furthermore, the following income is exempted from the withholding tax:

- Interest income of foreign governments on loans to the Chinese government
- Interest income of international financial organizations on loans with preferential terms to the Chinese government and resident enterprises
- Other income determined by the State Council.

Currently, dividends paid by FIEs to foreign shareholders are exempted from withholding tax. Starting on January 1, 2008, a 10 percent withholding tax will be imposed on dividends paid to nonresident enterprises unless an applicable tax treaty provides for a lower tax rate.

The EIT Regulations provide source rules for the allocation of income into and outside of China. The table below shows the source rules that are relevant to the withholding tax.

Type of Income	Sourced to
Gain on transfer of immovable property	Location of property
Gain on transfer of movable property	Residence of transferor
Gain on transfer of equity investment	Residence of invested enterprise
Dividend	Location of paying enterprise
Interest, rental, and royalty	Location of enterprise or establishment or place of business that actually bears or pays these items or the residence of individual who bears or pays such items

The EIT Law and the New EIT Regulations confirm that the withholding obligation occurs at the time of actual payment or the time at which the payment is supposed to be made. This means that when the amount is due and payable and the payer accrues expenses according to accounting standards, the payer will be obligated to withhold and pay the tax regardless of whether the payer has actually made the payment to the payee.

If a foreign company performs engineering projects or provides services in China that constitute a permanent establishment or an establishment, the foreign company should perform tax registration and pay EIT. However, the EIT Law and the New EIT Regulations provide that the tax authorities may appoint the payer as the withholding agent. If a foreign contractor does not pay Chinese tax on a taxable project, the tax authorities may seek to recover such taxes from other Chinese sources of income of the foreign enterprise.

LIMITATIONS ON DEDUCTION OF EXPENSES

In computing taxable income, the EIT Law allows an enterprise to deduct reasonable expenses in relation to income actually incurred. The New 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	Excess Expense Carryforward
Employee welfare	14 percent of total salary	No
Union fee contribution	2 percent of total salary	No
Workers education	2.5 percent of total salary	Yes, indefinitely
Business entertainment	60 percent of such actual expense up to 0.5 percent of business revenue	No
Advertising	15 percent of revenue	Yes, indefinitely
Charitable contribution	12 percent of profit before tax	No

The EIT Law provides that sponsorship expenses are not deductible. The New EIT Regulations clarify that the “sponsorship expenses” are the non-advertising expenses that are not related to business activities of an enterprise. As most

activities of an enterprise are directly or indirectly related to the business of the enterprise, it is not clear what kinds of expenses should be classified as those not related to business activities. In current practice, tax officials often view sports sponsorship and some other sponsorship expenses as nonbusiness-related expenses. This provision of the New EIT Regulations leaves room for interpretations in practice.

MANAGEMENT FEE

The New EIT Regulations provide that the management fees paid between enterprises are not deductible. Under current income tax law, management fees paid by an FIE to affiliates are not deductible. The New EIT Regulations apparently extend the application of this provision to all enterprises. As such, the overhead charges from a parent company to a subsidiary should not be deductible. It is not clear, however, whether the provision is intended to apply to management fees paid to unrelated parties. It would be unreasonable to disallow a deduction of management fees paid for unrelated party management services. The provision does not prevent an enterprise from deducting related party service fees. As such, an enterprise may still claim a deduction for reasonable fees paid to related parties for specific services.

AMORTIZATION OF INTANGIBLE AND PURCHASED GOODWILL

Intangible property generally can be amortized 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, such a useful life can be used as an amortization 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 amortized for 10 years. The new rule will disallow such amortization and, therefore, increases the amount of taxable income associated with acquiring business. The New EIT Regulations do not provide detailed rules on the allocation of the purchase price. Presumably, the purchaser and seller may agree to the price allocation based on the fair market value of the assets, rather than book value of the assets. It is not clear whether the purchaser or both parties may allocate a portion of the purchase premium over the net book value of the assets to some identifiable intangibles that were not on the seller's books. Those intangibles may include the in-process R&D, customer list, and noncompetition agreements.

ENTERPRISE REORGANIZATION

Neither the EIT Law nor the New EIT Regulations provide specific rules on enterprise reorganization. The original draft submitted to the State Council contained one subchapter on enterprise reorganization. The subchapter was, however, deleted from the final version of the regulations. Instead, 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 recognized at the time of the transaction in enterprise reorganization. Furthermore, the tax basis of the assets should be determined based on the transaction price. Under current tax regulations, tax-free reorganizations are available for certain reorganizations. Due to the absence of any specific reliefs in the New EIT Regulations, all transactions in relation to enterprise reorganizations will be taxable events starting on January 1, 2008. It is, however, expected that the Ministry of Finance and/or the State Administration of Taxation will issue rules on enterprise reorganizations.

DIVIDENDS BETWEEN RESIDENT ENTERPRISES

If a resident enterprise directly invests in another resident enterprise, the dividends received by the investing resident enterprise from the invested enterprise are exempted from income tax. However, tax-exempted dividend does not include income derived from investments in shares issued to the public by the dividend-paying enterprise and traded on a stock exchange when the holding period of such shares is less than 12 months. This exception creates some ambiguities. If a resident enterprise has an unlisted subsidiary, the resident parent enterprise is exempted from EIT on the dividends paid by the subsidiary. It is not clear whether the parent will be liable for EIT on the dividends if and when the subsidiary is subsequently listed because the parent holds the tradable shares for less than 12 months. Arguably, the parent company should continue to enjoy EIT exemption on the dividends as the shares held by the parent company are not those issued to the public, and the holding period prior to IPO should be accounted for. This interpretation would be in line of the tax policy eliminating double taxation.

If a resident enterprise acquires shares of publicly traded stock, the shares appear to fall into the definition of "issued to public and traded on a stock exchange." In such situation, the resident enterprise may be liable for EIT on the dividends received during the first 12 months even if it has acquired a controlling interest in the dividend-paying enterprise.

FOREIGN TAX CREDIT

An enterprise is allowed to credit foreign income tax paid on foreign-source income against the EIT liability of the enterprise. The foreign-source income includes (1) income derived outside China by a resident enterprise; and (2) income derived outside China by a nonresident enterprise that is effectively connected with an establishment or place of business of the nonresident enterprise in China. The foreign tax credit that can be used during the current year is limited to the EIT on the foreign source income as computed under the EIT Law. This limitation is computed country by country, not item by item. Excess credit can be carried forward for five years.

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 of the foreign enterprise. The EIT Regulations do not provide specific guidance regarding the calculation of ownership and the number of includable tiers of foreign subsidiaries. It is expected that the Ministry of Finance and the State Administration of Taxation will issue a tax circular to clarify the matter.

TAX INCENTIVES

The New EIT Regulations clarify some tax incentives, including those outlined below.

Tax Exemption and Reduction Without a Fixed Period. Tax exemptions are granted for income on investments in the following:

- The growth of vegetables, grains, potatoes, oil crops, beans, cotton, flax, sugar crops, fruits, and nuts
- New types of crop breeding
- The growth of Chinese herbal medicines
- The growth of forests
- Livestock and poultry farms
- The collection of forest products
- Irrigation services, preliminary processing of agriculture products, veterinarians, agriculture technology popularization, farming machinery operations and repairs, and other services for the agricultural, forestry, animal husbandry, and fishery industries
- Deep sea fishing.

Income derived from the following businesses is granted a 50 percent reduction in the tax rate:

- Flowers, teas and other beverage crops, and spice growing
- Sea farming and inland water farming.

Tax Incentive for a Fixed Period. An enterprise is exempted from income tax on the income from the following businesses for three years starting when the business begins to generate revenue; from the fourth until the sixth year of operations, such businesses will be allowed a 50 percent reduction their tax rates.

- Qualifying investments in public infrastructure facilities and industries, including harbors, airports, railroads, highways, city public transportation, power, and water conservancy projects
- Qualifying environmental protection projects as well as energy and water-saving projects, including public sewage treatment, public garbage disposal, comprehensive utilization and development of methane, energy-saving technology, tidal power, and seawater desalination.

Transfer of Technology. If an enterprise transfers qualified technologies, RMB 5 million in income derived from the transfer within a tax year will be exempt from tax; the remainder will be taxed at the tax rate otherwise applicable to the enterprise reduced by 50 percent.

High and New Technology Enterprise. A high and new technology enterprise enjoys a reduced tax rate of 15 percent. To qualify as a high and new technology enterprise, the enterprise must own its core intellectual property, and its products and services must be listed in *The Areas of High and New Technology Encouraged by the State*. Additionally, R&D expenditure must reach a required percentage of revenue; revenue from high-technology products and services must reach the required percentage of total revenue; and science and technology personnel must reach the required percentage of the total number of staff. The required percentages are not specified in the New EIT Regulations; therefore, further clarification will be required in subsequent tax and non-tax regulations.

The Areas of High and New Technology Encouraged by the State is going to be issued by relevant offices of the Chinese government. At present, many enterprises are recognized as high and new technology enterprises, but they will not automatically qualify as high and new technology enterprises under the EIT Law and the New EIT Regulations. New procedures for certification of the high and new technology enterprise are expected to be issued.

A key requirement under the New EIT Regulations for qualification as a high and new technology enterprise is ownership of core IP rights. This requirement is consistent with China's effort to promote R&D development and the ownership of technology in China. Yet the policy has placed many multinational companies at a disadvantage because their internal policies may require that their IP rights reside outside China. Therefore,

multinational companies may want to consider transferring IP rights that pertain only to China to their Chinese subsidiaries or allow their Chinese subsidiaries to own the IP rights in China through a cost-sharing arrangement.

Bonus Deduction for R&D and Hiring Disabled Persons. The EIT Law and the New EIT Regulations allow taxpayers to take extra tax deductions for the following expenses:

- Qualified R&D expenditure. If the cost is currently expensed, 150 percent of the cost is deductible for EIT purpose. If the cost is capitalized, 150 percent amortization is allowed.
- Employment of disabled personnel. If an enterprise hires disabled persons, the enterprise can deduct 200 percent of actual wages paid to disabled employees.

Early Recovery of Venture Capital Investment. If a venture capital enterprise makes an equity investment in an unlisted small or medium size high and new technology enterprise for two years or longer, the venture capital enterprise can deduct 70 percent of its investment from its current-year taxable income upon the completion of the two-year period. If the venture capital enterprise does not have sufficient income to absorb the deduction for that current year, the excess amount can be carried forward. The regulations do not provide a carryover period, and, even though net operating loss can only be carried forward for five years, it appears as though such deductions can be carried forward indefinitely. It should be noted that the early recovery of partial investment costs does not require a reduction of the tax basis for the investment. Because the New EIT Regulation does not define “small and medium size high and new technology enterprise,” further clarification will be required in this regard.

Accelerated Depreciation. Fixed assets generally are appreciated using a straight line method over the life of assets. The minimum recovery periods are 20 years for buildings; 10 years for trains, ships, aircrafts, 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 (1) need to be replaced quickly due to development of technology; or (2) 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.

Income Exclusion for Use of Special Materials. If an enterprise uses resources listed in the EIT Incentive Catalogue for Comprehensive Use of Resources as major raw materials in its production, the enterprise can include only 90 percent of its revenue from such products, subject to certain conditions, in the gross income of the enterprise.

Tax Credit for the Purchase and Use of Special Equipment. If an enterprise purchases and uses qualifying environmental protection, energy saving, water saving, or safe production equipment, the enterprise can take a tax credit equal to 10 percent of the purchase price of the equipment. If the tax credit cannot be fully utilized in the year generated, the excess credit can be carried forward for five years. Such a tax credit will not reduce the tax basis of the equipment and is subject to recapture if the enterprise disposes of or leases out the equipment within five years.

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, including the comparable uncontrolled price method, resale price method, cost plus method, transactional net margin method, profit split method, and other methods under the arm's length principle. The EIT Law and the New EIT Regulations provide for the availability of advanced transfer pricing arrangements.

The EIT Law and the New EIT Regulations allow for the appropriate allocation of shared costs in accordance with the arm's length principle. The New EIT Regulations stipulate that shared costs should be allocated based on matching principle between cost and expected income. All enterprises should submit the relevant materials to the tax authority within the required timeframe.

CONTROLLED FOREIGN CORPORATION (“CFC”)

Under the New EIT Regulations, a foreign enterprise is considered to be a CFC if (1) 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 (2) although not satisfying (1), resident enterprises control the foreign enterprise via equity, financing, operations, or purchase and sales relation. 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.

THIN CAPITALIZATION

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, including:

- a back-to-back loan for which a related party provides a loan through an unrelated party.
- an unrelated party loan guaranteed by a related party or secured by the assets of a related party.
- any other investment in debt indirectly obtained from a related party.

The New EIT Regulations do not give specific standards regarding the debt-to-equity ratio; instead, the New EIT Regulations authorized 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 March 16, 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.
- if enjoying tax holidays for a fixed period under current laws and regulations, such enterprises can continue the 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 March 16, 2007. The New EIT Regulations did not offer further clarification on the transition rules. It is expected that detailed guidance on the application of tax incentive during the transition period will be issued by the Ministry of Finance and State Administration of Taxation subsequently.

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