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Implementation Rules for the new PRC Enterprise Income Tax Law

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The State Council of the PRC finally approved the Implementation Rules for the new PRC Enterprise Income Tax Law, which was drafted by the Ministry of Finance and the State Administration of Taxation, on 6 December 2007. The Implementation Rules provides interpretation, explanation and implementation details to the new PRC Enterprise Income Tax Law (“Tax Law”) effective on 1 January 2008 with a standard enterprise income tax rate of 25%.

The salient points of the Implementation Rules are summarized as below:

Withholding Tax Rate

The withholding tax rate of 20% under the new Tax Law on China-sourced passive income such as dividend, royalties, interest, rentals and capital gains, etc derived by foreign companies is reduced to 10% under the Implementation Rules. It means that the 10% tax rate shall be applicable to all foreign companies no matter the companies are from a treaty country/region or not. The relevant tax treaties may be applied if they provide a more favorable rate.

Tax Resident Enterprise (“TRE”)

The new Tax Law introduces the concept of TRE. It provides that a foreign company which has its place of effective management in China shall be considered a TRE in China. A TRE in China shall be subject to Enterprise Income Tax in China on its worldwide income.

The Implementation Rules defines “the place of effective management” as “the establishment that exercises, in substance, the overall management and control over the production and operation, personnel, financial accounting, properties, etc of an enterprise.

Tax Incentives

The new Tax Law removes the tax holiday of “2-year exemption followed by 3-year 50% reduction” granted to all manufacturing foreign investment enterprises (“FIEs”) under the existing Foreign Enterprise Income Tax Law. However, it provides a 5-year grandfathering relief to FIEs established on or before 16 March 2007.

The tax incentives granted under the new Tax Law include mainly the following:-

Preferential rate

The new Tax Law grants a preferential tax rate of 15% to high-tech enterprises specifically supported by the State. The Implementation Rules defines the “high-tech enterprises specifically supported by the State” as enterprises that own the core proprietary intellectual property (“IP”) rights and fulfill all of the following conditions:-

- Products (services) fall within the prescribed scope of “High-Tech Sectors Specifically Supported by the State”;
- R&D expenses shall not be less than the prescribed percentage of sales income;
- Income from high-tech products (services) shall not be less than the prescribed percentage of total income;
- The number of technical people shall not be less than the prescribed percentage of total employees; and
- Other conditions as prescribed in the administrative measures of the assessment of the high-tech enterprises.

The “High-Tech Sectors Specifically Supported by the State” shall be jointly formulated by the competent science technology, finance and tax department of the State Council.

Tax exemption or reduction

The new Tax Law grants tax exemption or reduction to enterprises deriving income from the following activities or projects:

- Agricultural, forestry, husbandry, fishery activities;

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- Public infrastructure, environmental protection, energy or water conservation projects;
 - Technology transfer fulfilling certain conditions.

The Implementation Rules provides further details on the following:

- Specifying what activities that the agricultural, forestry, husbandry, fishery activities refer to, and what activities can enjoy exemption or 50% reduction.
- Specifying what projects that the public infrastructure, environmental protection, energy or water conservation projects refer to, and that those project can enjoy 3-year tax exemption followed by 3-year 50% reduction from the year of first deriving production and operation income.
- Specifying that, for income derived by a resident enterprise from the transfer of technology in a tax year, the portion not exceeding RMB5 million shall be exempted from enterprise income tax; and the portion exceeding RMB5 million shall be allowed for a 50% reduction,

Tax Deduction

The Implementation Rules sets deduction cap for some items of expenses and specifies certain disallowed expenses, some of which as below are new and not specified in the existing Foreign Enterprise Income Tax Law.

- Business entertainment expenses: only 60% of the actual expenses are deductible, with a cap of not more than 0.5% of annual sales income.
- Advertising and business promotion expenses: deductible amount is capped at 15% of annual sales income, and the exceeding portion can be carried forward to future years for deduction.
- Commercial insurance expenses paid for employees are generally not deductible.
- Management fees paid between enterprises are not deductible.
- Sponsorship expenses of non-advertising nature are not deductible.

Contemporaneous Transfer Pricing Documentation Requirement

The new Tax Law addresses the requirement for filing related party transactions report when filing annual tax returns with the tax authority. In addition, during a transfer pricing investigation to an enterprise, the concerned enterprise and its related party, as well as other enterprises involved in the investigation, should provide the relevant information.

The Implementation Rules elaborates that the “relevant information” includes:

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- The relevant information documentation regarding the determination standards, computation methods and explanation of the prices and expenses in relation to the related party transactions; and
 - The relevant information regarding the resale (or transfer) prices or ultimate sale (transfer) prices of properties, rights to use of the properties and services in relation to the related party transactions.

The Implementation Rules also specifies that, where an enterprise conducts transactions with its related parties not based on arm's length principle, the tax authority shall have the right to make tax adjustments within 10 years starting from the year during which such a transaction takes place.

“Controlled Foreign Corporation” Rule (“CFC” Rule)

The new Tax Law introduces the CFC Rule which is applicable to an enterprise controlled by Chinese resident enterprises and established in a country (region) where the effective tax burden is substantially lower than the standard enterprise income tax rate in China, i.e., 25%.

The Implementation Rules clarifies that “the effective tax burden is substantially lower than the standard enterprise income tax rate in China” refers to the case where the effective tax rate is lower than 50% of the standard enterprise income tax rate, i.e., lower than 12.5%.

Thin-Capitalization Rule

The new Tax Law introduces the Thin-Capitalization Rule that disallows the interest deduction on interest-bearing debts or loans from related parties if the ratio of debt to equity investment exceeds the prescribed ratio requirement.

The Implementation Rules provides definitions for “debts” and “equity”. “Debts” refers to financing directly or indirectly obtained by an enterprise from its related parties that requires repayment of principal and interest. “Equity” refers to investment obtained by an enterprise without the need of the repayment of principal and interest, and the investor having the entitlement to the net assets of the enterprise.

General Anti-Avoidance Rule

The new Tax Law introduces the general Anti-Avoidance Rule which provides that, if an enterprise engages in an arrangement without reasonable commercial purposes that results in reducing its

taxable income, the tax authority has the right to make adjustments based on reasonable methods.

The Implementation Rules clarifies that “without reasonable commercial purposes” refers to the case where the main purpose is for the reduction, exemption or deferral of tax payments.

Our Comment

It is obvious that the Implementation Rules does not clarify all the uncertain issues in the new Tax Law. There are still a lot of unclear issues and therefore further interpretation, explanation and implementation details on those issues from the authorities are necessary. Probably, the Chinese central government would like to leave those issues to lower-hierarchy authorities namely the Ministry of Finance and the State Administration of Taxation. It is expected that supplementary Tax Circulars would be issued by the Ministry of Finance and the State Administration of Taxation from time to time in the coming period and the clarification process may possibly take months or even years.

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More Information

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