

September 2007

Chinese Tax Reform – Matters Requiring Urgent Attention

We previously issued an alert about new PRC tax law changes. These changes take effect from 1 January 2008. This represents the most significant tax reform ever undertaken by the PRC. To review our previous alert, please click [here](#).

For more information contact:

Jon Eichelberger

Tel: +86 10 6535 3868
jon.eichelberger@bakernet.com

Brendan Kelly

Tel: +86 21 6105 5950
brendan.kelly@bakernet.com

Michael Olesnicky

Tel: +852 2846 1716
michael.olesnicky@bakernet.com

Baker & McKenzie LLP
Suite 3401, China World Tower 2
China World Trade Center
1 Jianguomenwai Dajie
Beijing 100004, PRC
Tel: +86 10 6535 3800
Fax: +86 10 6505 2309

Baker & McKenzie LLP
Unit 1601, Jin Mao Tower
88 Century Avenue, Pudong
Shanghai 200121, PRC
Tel: +86 21 6105 8558
Fax: +86 21 5047 0020

Baker & McKenzie
14th Floor, Hutchison House
10 Harcourt Road
Central, Hong Kong SAR
Tel: +852 2846 1888
Fax: +852 2845 0476

Much of the detail of the new tax laws will be contained in the Implementing Rules, which will be issued sometime between now and the end of November. However, to take advantage of some of the opportunities presented by the new tax rules, certain issues must be addressed as soon as possible, if they are to be feasibly implemented before the end of 2007. Because of the time period required to implement corporate steps in the PRC, decisions must be made now. Things to think about are the following.

Dividends

From 1 January 2008, a 10% withholding tax will likely apply on dividends paid by foreign-invested enterprises to shareholders abroad. You should consider paying out dividends generated from pre-2007 earnings before the end of December, in order to take advantage of the existing exemption from withholding tax.

Holding Companies

To reduce the normal withholding tax rate on dividends from 10% to 5%, the ownership of PRC enterprises could be transferred to a new holding company established in jurisdictions that have favourable tax treaties with the PRC. Examples are Hong Kong, Singapore, Mauritius and Barbados. (Generally, the 5% rate only applies if the foreign investor owns 25% or more of the PRC entity.)

Reinvestment Refund

Under current rules, foreign investors can obtain a tax refund of 40% or 100% (depending on the case) of the amount of profits of their PRC entities which are reinvested into that entity. This benefit will cease as from January 2008. Any such reinvestment decision must be made and implemented before the end of 2007, in order to obtain the tax refund. As the entire process usually takes two to three months, the decision must be made immediately.

Tax-free Restructurings

Currently, interests in PRC entities may be transferred within a 100%-commonly owned corporate group, free of PRC capital gains tax, provided the transfer is done with a "reasonable business purpose." (For this purpose, the transfer must be effected at the original cost price, thereby avoiding the recognition of a gain.) It is likely that, as from January 2008, the exemption will only be available if the transferee is a PRC entity. This means that reorganisations involving the transfer of PRC holdings into offshore holding companies in the group will no longer qualify for a capital gains tax deferral. Any such reorganisation must be implemented absolutely urgently. This is because at least a couple of months would be required to obtain the necessary governmental consents to permit transfers to be made before the 31 December deadline.

Mauritius/PRC Tax Treaty

Changes to the Mauritius/PRC tax treaty will take effect as from 1 January 2008. These changes will abolish the capital gains tax exemption that applies today if a Mauritian holding company disposes of an interest of greater than 25% in a PRC entity. If you utilise a Mauritian holding company to hold your PRC interest, you should consider transferring those interests now to a new Mauritian holding company, thus realizing a tax-free step-up in cost price (and thus reducing PRC capital gains tax on future disposals). Again, for this to be done within the deadline, the necessary governmental consents must be sought urgently.

Your Next Step

Our Baker & McKenzie's lawyers in Greater China are ready to help you to consider and implement any of these proposals. For further information, please contact any of our tax partners listed.