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Tax Planning Strategies in Response to China's Changing Tax Landscape: *issues and structures to be considered in a post tax unification China*

The National People's Congress passed the new Enterprise Income Tax Law ("New EIT Law") on March 16, 2007. The law will become effective on January 1, 2008. It provides unified treatment for foreign-invested enterprises ("FIEs") and domestic enterprises. It is the most important change China's tax system has ever seen, as measured by the combination of the actual technical scale of the changes as well as the importance of China to the global market and the strategies of so many multinationals ("MNCs").

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What does this change mean to most MNCs and what action should be taken?

To most investors, the New EIT Law will result in a substantially higher tax burden with the elimination of most preferential tax rates and holidays and a harmonized tax rate of 25%. Many companies are currently subject to 15% or 24% tax rates, coupled with tax holidays to eliminate or reduce by half the applicable tax rate for a number of years (depending on the specific tax incentive). With the elimination of many such rates and incentives, the focus for PRC tax planning must necessarily shift from seeing the PRC as a low-tax location where it is desirable to recognize profits to a relatively high-tax jurisdiction in which the goal is to minimize taxable profits.

This article will first explain the key changes in the New EIT Law and will then discuss tax minimization options foreign investors ought to consider in the context of the New EIT Law.

1. Major Changes

1.1 Elimination of Tax Incentives for FIEs

The change introduced by the New EIT Law that has the greatest impact on FIEs is the elimination of the current tax incentives available to FIEs.

The current system allows qualified production FIEs with operating periods of

at least 10 years to enjoy a tax holiday consisting of a two-year tax exemption and a 50% reduction in the tax rate for the next three years beginning from the first profit-making year. After the expiry of the tax holiday, if an FIE qualifies as an export oriented enterprise (“EOE”) for a particular year, it can further enjoy a 50% reduction of the tax rate with a floor of 10% for that year.

The 2+3 holiday (plus a number of other holidays of different forms and requirements) and reduced tax rate for EOE are abolished by the New EIT Law. However, an FIE that has already obtained its business license and commenced its tax holiday before the effective date of the New EIT Law can continue to enjoy the full tax holiday. For FIEs that have not yet commenced their tax holidays due to accumulated tax losses, the tax holiday will start in 2008.

Besides the tax holiday mentioned above, the current system confers preferential tax rates, i.e. 15% or 24%, on qualified FIEs located in specific geographical locations. These geographic concessionary rates will be abolished, except in special circumstances provided in the New EIT Law. One special circumstance is that qualified FIEs and domestic enterprises located in the Western and Central districts of China will continue to enjoy concessionary rates.

The New EIT Law provides for a transition period of five years for FIEs that currently enjoy concessionary rates. The tax rate for these existing FIEs will increase gradually from the current concessionary rate to the new rate of 25%. For example, for FIEs currently enjoying a 15% rate, the income tax rate will be 15% in 2008, increase to 17% in 2009, 19% in 2010, and continue to increase by two percentage points each year until finally reaching 25% in 2013¹. It is likely that the grandfathering period will be available only to those companies that have obtained their business licenses before March 16, 2007. However, it is unclear whether a company that has obtained its business license before March 16, 2007, but only starts to qualify for a certain tax incentive after March 16, 2007, will be able to take advantage of the grandfathering period.

As the March 16, 2007 deadline has already passed, it is too late to establish new FIEs to take advantage of the grandfathering provision. However, foreign investors who want to do business in China can acquire existing FIEs that qualify for grandfathering instead of setting up new FIEs. The acquisition must be in the form of a share deal rather than an asset deal. After the share acquisition, the foreign investor should be able to expand the scale of the operation without losing the current tax incentives as long as the business scope of the FIE remains unchanged.

Besides the national tax incentives, many localities have local “tax” incentives in the forms of subsidies and rebates to attract foreign investments. For example, according to Shanghai local policies, all FIEs in Pudong, instead of only production FIEs as prescribed under the national rules, can enjoy the

¹ There is still debate over whether the phasing will start with 15% or 17% in 2008, but the 2% increase annually appears to be something agreed to amongst the relevant authorities.

15% EIT rate. Many MNCs are concerned about how the local incentives will be affected by the New EIT Law. The central government has repeatedly insisted that local governments stop offering local tax incentives (as these incentives are in conflict with national law) but this has not been very effective. Therefore, it is very likely that local governments will continue to offer local incentives after the New EIT Law becomes effective.

Illustration of the Grandfathering Mechanism

The grandfathering of both tax holidays and concessionary rates offered by the new EIT Law can be illustrated by the following example:

Year	2007	2008	2009	2010	2011	2012	2013
Tax Regime	FEIT Law	5-year transition period					New income tax law
Statutory Tax %	15%	15%	17%	19%	21%	23%	25%
Tax Holiday	N/A	Two-year exemption		Three-year 50% reduction			N/A
Effective Tax %	0%	0%	0%	9.5%	10.5%	11.5%	25%
Profit/Loss	Loss	Loss	Profit	Loss	Loss	Profit	Profit
Cash Tax %	0	0	0	0	0	11.5%	25%

- (i) A production FIE entitled to 2+3 holiday and located in Shenzhen;
- (ii) The first profit-making year is in 2009;
- (iii) It does not qualify for other tax incentives under the new income tax law;

The New EIT Law also repeals the reinvestment refund for foreign investors. Under the current system, if a foreign investor reinvests its profit from its PRC operation to expand the existing operation or start a new operation by turning retained earnings into registered capital, it can get back 40% or 100% of the EIT paid on such profit. The New EIT Law does not have a reinvestment refund provision. It thus appears that reinvestment made in 2008 of profits generated in 2007 will not be eligible for the tax refund. Further, obtaining the investment refund is a lengthy process. Therefore, if a foreign investor has profits in China and still wants to take advantage of the reinvestment refund benefit, it should act fast to do so within 2007.

1.2 New Tax Incentives

Although the New EIT Law repeals most tax incentives for FIEs, it provides tax incentives to both FIEs and domestic companies who invest in the following selected industries and enterprises:

- High & New Technology Enterprises (“HNTEs”);
- Venture capital;

- Environmental protection, water-saving, energy-saving, and safer production;
- Agriculture, forestry, animal husbandry, fishing industries and infrastructure-like port, wharf, airport, railway, expressway, electricity, water conservancy facilities; and
- Labor service enterprises and welfare enterprises.
- There will be new regulations issued to provide detailed implementation rules and requirements for the above incentives. Foreign investors who invest in these industries should ensure that their PRC operations are properly structured to take advantage of the incentives.

For HNTEs, the New EIT Law provides a 15% EIT rate. It is also likely that the implementation rules will provide additional tax holidays to HNTEs. The new qualification requirements for HNTEs will likely require that an HNTE own the relevant intellectual property. This presents a particularly difficult problem to most MNCs, which tend to avoid having their intellectual property reside in China in view of China's unreliable IP protection environment.

1.3 Withholding Tax

Unlike the current law, the New EIT Law does not include a withholding tax exemption for dividends paid by FIEs to foreign investors. However, it gives power to the State Council to exempt or reduce taxes related to foreign enterprises' passive income, such as dividends. The implementation rules to be issued by the State Council will clarify the withholding tax position. It is expected that the implementation rules will confirm that dividends distributed by FIEs will be subject to withholding tax, most likely at a rate of 10%. The rules are also expected to continue the present policy of levying withholding tax on other types of passive income received by foreign companies at a rate of 10%, rather than at the standard 20% rate provided in the both the existing income tax law and the New EIT Law.

1.4 General Anti-Avoidance Provision

Another significant change under the New EIT law is the introduction of new collection and enforcement measures.

MNCs are perceived in some quarters to engage in tax avoidance in China. According to estimates by the State Administration of Taxation ("SAT"), the tax revenue lost because of tax avoidance by MNCs amounts to RMB30 billion (approximately US\$3.8 billion) each year. Many MNCs have countered that they are tax compliant and have pointed their fingers at more aggressive and illegal practices by domestic companies.

Nonetheless, this concern regarding MNCs' practices has been the stated basis for the need for these new collection and enforcement measures (although many people suspect the true reason is a concern about PRC nationals setting up offshore companies to sell their investments without reporting PRC tax). The new law introduces a general anti-avoidance provision, specific anti-avoidance rules and new collection rules.

The general anti-avoidance provision in the new law mirrors the general anti-avoidance rule commonly adopted by other jurisdictions. If a transaction or a structure does not have a reasonable business purpose and results in a decrease of taxable income, the tax authorities have the power to “see through” the transaction or structure and to adjust the taxable income as if the parties had not conducted the transaction or adopted the structure. Further, the taxpayer will be required to pay a late payment surcharge on any adjustment.

However, putting in place a general anti-avoidance rule is only the first step. Presumably, the implementation rules will provide further guidance on how this provision should be enforced. Specific issues are what constitutes “business purpose” and how to interpret “reasonableness”. Even with such further clarifications, given the broad scope of the language in the New EIT Law, local tax officials may still have too much discretion, as a result of which taxpayers may still face great uncertainties in their tax planning.

1.5 Late Payment Interest on Transfer Pricing Adjustments

The New EIT Law also further cracks down on transfer pricing arrangements by imposing interest on the payment of additional taxes imposed as a result of transfer pricing adjustments. The same interest rule also applies to other tax adjustments under the general anti-avoidance rule, thin capitalization rule and CFC rule. This rule may have a significant impact on the transfer pricing strategy of MNCs’ operations in China.

According to the existing transfer pricing rules, neither interest nor penalties can be imposed on transfer pricing adjustments. Under the existing rules, if taxpayers adopt aggressive transfer pricing policies in China and tax authorities make an adjustment later, taxpayers may still have successfully delayed paying tax without any interest or penalty. The New EIT Law closes this loophole.

The rate of late-payment interest is 0.05% per day, equal to 18.25% per year. Considering that a transfer pricing audit can extend back 10 years and that the tax authorities have become more and more aggressive in transfer pricing audits, MNCs should be more cautious in their future transfer pricing planning. Having proper transfer pricing documentation should be part of this planning. New transfer pricing documentation rules are expected to be issued before the end of 2007. This means that, from January 1, 2008, MNCs are likely to be subject to mandatory documentation rules.

It is unclear whether the interest provision will be applied retroactively. Implementation rules should clarify whether interest will be imposed on transfer pricing adjustments made by the tax authorities after the commencement of the New EIT Law on income from prior years.

1.6 Thin Capitalization

Besides the general anti-avoidance provision, the New EIT Law also introduces provisions targeting certain specific tax avoidance activities. One of them is the new thin capitalization rule.

The current EIT system for domestic companies has a thin capitalization rule, which disallows deductions of interest expenses if the loans borrowed from affiliated companies exceed 50% of the registered capital of the domestic company. There is no limitation on the deduction of interest expense under

the current EIT system for FIEs.

The New EIT Law provides that, if the amount of inter-company loans borrowed from affiliated companies exceeds a certain debt-equity ratio, the relevant interest expenses will not be deductible for tax purposes. Implementation rules will further define the applicable “debt-equity ratio”. It is likely that the standard will follow the 50% rule in the old EIT Law for domestic companies. Further, it is likely that the thin capitalization rule will capture indirect borrowings as well, such as entrusted loans.

Although there are no thin-capitalization rules under the current EIT system for FIEs, the State Administration of Industry and Commerce has set debt-equity standards for FIEs, as follows.

Total Investment	Minimum Equity (% of Total Investment)
Up to US\$3M	70%
US\$3 – 10M	50% or US\$2.1M (whichever is higher)
US\$10 – 30M	40% or US\$5M (whichever is higher)
Over US\$30M	33.3% or US\$12M (whichever is higher)

In practice, the above debt-equity ratios are only enforced in the context of foreign exchange loans. If an FIE borrows a domestic currency loan, the above restriction is not strictly enforced. Under the new rules, however, the tax authorities likely will not distinguish between interest expense on domestic loans and foreign exchange loans. As long as the total loans borrowed from affiliated companies exceed the debt-equity ratio limitation, the deduction of interest expense will be disallowed. Therefore, after the New EIT Law becomes effective, FIEs should pay attention to the thin capitalization limitation under the New EIT Law even when they borrow in domestic currency.

1.7 Taxation of Non-Resident Enterprises

Non-resident enterprises will be taxed on two types of income:

- Active income: income related to an establishment in China, both PRC-sourced or non-PRC-sourced; and
- Passive income: PRC-sourced income not related to an establishment in China.

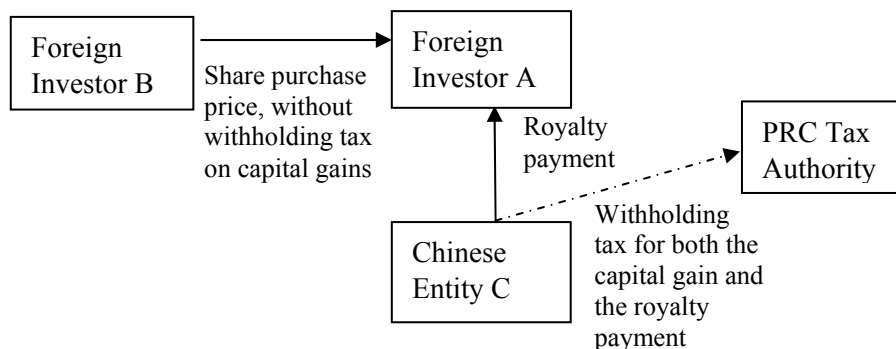
An important point is that the New EIT Law expands the definition of active income. The current EIT Law only taxes non-resident enterprises on PRC-sourced income. However, the New EIT Law will tax non-PRC-sourced income of a foreign enterprise, as long as the non-PRC-sourced income is “effectively connected” to a non-resident enterprise’s establishment in China. As a result, foreign companies doing business in China could face greater tax exposure in China under the New EIT Law. It is therefore advisable for a foreign company that conducts business in China through an establishment to do so through a jurisdiction that has a tax treaty with China to take advantage

of treaty protection regarding income attribution.

Further, the New EIT Law also gives more power to the tax authorities to collect delinquent taxes from non-resident enterprises.

Under the New EIT Law, if a foreign company has PRC-sourced income, taxes are normally paid through a withholding agent. However, if for some reason there is no withholding agent or the withholding agent does not withhold the tax, and the foreign company does not pay the tax itself, the Chinese tax authorities have the power to collect the delinquent tax from other income that the foreign taxpayer receives from China.

A common situation of no withholding agent is where Foreign Investor A sells its investment in an FIE to Foreign Investor B. Foreign Investor B, as a foreign company, does not withhold tax on the capital gains of Foreign Investor A. If Foreign Investor A does not pay tax itself, the tax authorities under the new law will be entitled to collect the tax on the capital gains from other income that Foreign Investor A receives from China, e.g., royalties, dividends, service fees, rentals or interest.



Because the New EIT Law will eliminate most of the current tax incentives available to FIEs, the tax cost to an MNC doing business in China may increase significantly if careful planning is not carried out. MNCs naturally ought to take advantage of new tax incentives available to the high tech industry and certain less developed regions. However, a large percentage of foreign investors use China as a manufacturing base, and many others source from or sell to China. These companies may not be able to qualify for new tax incentives. Thus, they must try to explore other options to minimize the tax cost of their PRC operations.

In the next two sections, we will discuss tax treaty planning and restructuring and tax minimization strategies that involve moving risks and functions out of China.

2. Effective Use of Tax Treaties

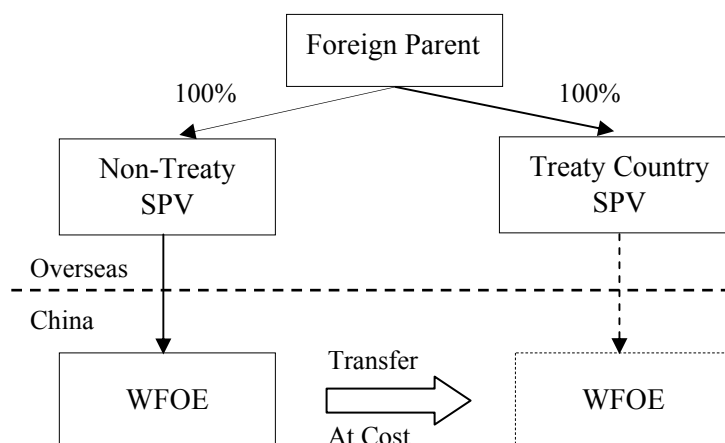
As discussed above, the New EIT Law provides for withholding tax on dividends paid to overseas shareholders, but gives the State Council the authority to exempt or reduce withholding tax. Historically, China exempted dividends paid by FIEs to foreign investors. Thus, little tax planning was needed to mitigate dividend withholding tax.

At the same time, many foreign investors used vehicles in non-treaty jurisdictions such as the British Virgin Islands (BVI) or Cayman Islands to hold their PRC investments, with the goal of selling the BVI or Cayman company as a future exit strategy and thereby avoid withholding tax in China on the resulting capital gains.

The New EIT Law provides for a 20% withholding tax rate on passive income received by foreign companies from PRC sources, and it is expected that the current dividend withholding tax exemption will not continue. Therefore, if an FIE is held by an offshore company resident in a jurisdiction that does not have a treaty with China, the dividends that the offshore company receives from China may be subject to withholding tax in the future at a higher rate than would apply if the offshore company was resident in a treaty jurisdiction.

In order to minimize the withholding tax impact, foreign investors should consider transferring their holdings in PRC subsidiaries from their current holding companies located in non-treaty jurisdictions to holding companies located in jurisdictions that have favorable treaty terms with China. An example of this kind of transfer is depicted in Figure 1.

Figure 1 - Offshore Holding Company



2.1 Popular Jurisdictions for Setting up Holding Companies

In the past, Barbados and Mauritius have been popular intermediary holding locations because of their capital gains exemptions in the PRC on the disposal of shares in a Chinese company. In the case of Mauritius, the assets of the Chinese company could not be mainly comprised, directly or indirectly, of immovable property situated in China. Barbados has been a popular choice in real estate projects because the capital gains exemption in the China/Barbados tax treaty did not carve out real estate investments in China.

On September 5, 2006, a new protocol was signed by China and Mauritius to reduce the scope of the capital gains exemption under the existing 1994 tax treaty. According to the relevant capital gains article which will come into force in China on January 1, 2008, capital gains realized by a Mauritius investor will be taxed in China if that Mauritius investor owned more than 25% of the equity in a Chinese company at any time in the previous twelve months. In connection with the recent tax unification, there have been rumors and various unofficial statements by SAT officials that, whilst the full capital

gains tax exemption remains effective for Barbados right now, they intend to follow the same path as in the case of Mauritius. Thus, the strong expectation is that the Barbados capital gains exemption will be eliminated in the near future.

Hong Kong has more recently positioned itself as a favorable jurisdiction to set up holding companies for PRC operations because of the Hong Kong/Mainland double tax arrangement signed in late 2006. Under this tax arrangement, a Hong Kong company can take advantage of relatively low withholding taxes on interest and royalties (7% each) and dividends (5%). On the Hong Kong side, Hong Kong does not tax dividends and capital gains, and interest and royalty income can be tax-exempt in Hong Kong with proper planning.

The chart below compares the withholding tax rates for the above-mentioned jurisdictions.

Category of Income/ Location	No Treaty	Hong Kong	Mauritius	Barbados	Singapore
Interest	10%	7%	10%	10%	7%/10%* **
Dividends	Exempt*	5%**	5%	5%	7%**
Royalties	10%	7%	10%	10%	10%
Capital Gains on shares with 25% or more holding	10%	PRC may tax	PRC may tax****	Exempt	PRC may tax

*Currently after-tax dividends from an FIE are exempt from withholding tax under PRC domestic law. However, this exemption is likely to be repealed in connection with the implementation of the New EIT Law.

**>25% shareholding required, or the rate increases to 10% for Hong Kong or 12% for Singapore.

***For the PRC-Singapore Treaty, 7% on interest paid to a Singapore financial institution, and 10% in all other cases.

****Starting from 2008; currently still exempt.

2.2 Tax-free Restructuring

The transfer of shares from one offshore holding company to another can be done tax-free in China. Generally speaking, shares of an FIE should be transferred between related parties at fair market value (“FMV”). However, according to Circular *Guo Shui Han [1997] No. 207* issued by the SAT on April 17, 1997, as part of a company reorganization for reasonable business purposes, if a foreign company or an FIE transfers its shares in an FIE to another company that has a relationship with it involving direct or indirect 100% ownership, the shares may be transferred at cost. Therefore, as long as the two offshore holding companies have the same direct or indirect parent,

the PRC subsidiary can be transferred from one holding company to another at cost. As a result, there would be no capital gain to trigger PRC withholding tax.

2.3 Disposal and Exit Strategies

While other countries may continue to provide a capital gains tax exemption (e.g., Switzerland), Hong Kong is attractive in that it can access the lowest withholding rates generally available, achieve an efficient Hong Kong tax burden and permit tax-free repatriation from Hong Kong. Upon disposal of the Hong Kong company, there is a limited Hong Kong exposure as long as the transaction is capital in nature. This is because capital gains are exempt from tax in Hong Kong. However, there is a Hong Kong stamp duty of 0.2% on share transfers, but this may not be high enough to justify the more complex planning available.

Thus, while the diagram describes a move from a “non-treaty” to a “treaty” location, one can easily see a number of scenarios and locations, including a move from one treaty jurisdiction to a more favorable treaty jurisdiction. Hong Kong is a strong choice, but specific analysis depends on the types of income an investment may generate, the likely length the investment will be held and, of course, home country tax rules.

3. Tax Minimization Strategies

We now turn to several tax planning strategies for manufacturing operations and sourcing/distribution activities. The goal is to move risks and functions (to the extent possible) outside the PRC tax net. To do so requires moving real risks, authority and functions offshore. With China being such an important part of global businesses today, it is very important to assess such structures while understanding functionally what the business can actually support and allow.

We discuss below two types of contract manufacturing arrangements as well as a limited risk/function sales and procurement structure as potential means to lower PRC reportable profits without substantially impacting the day-to-day business of the company in China.

3.1 Use of Contract Manufacturing Structures

Many foreign companies have manufacturing operations in China in the form of a Wholly Foreign-Owned Enterprise (“WFOE”). The WFOE will import or purchase raw materials in China. It will then sell the finished products to PRC customers or export them to offshore customers. The WFOE, as a manufacturing FIE, often enjoys a lower tax rate and tax holidays under the current system. If more than 70% of the WFOE’s products are exported, the WFOE can enjoy a further tax reduction. Therefore, the tax cost of manufacturing in China has been very low – the effective income tax rate may be 10% or even lower.

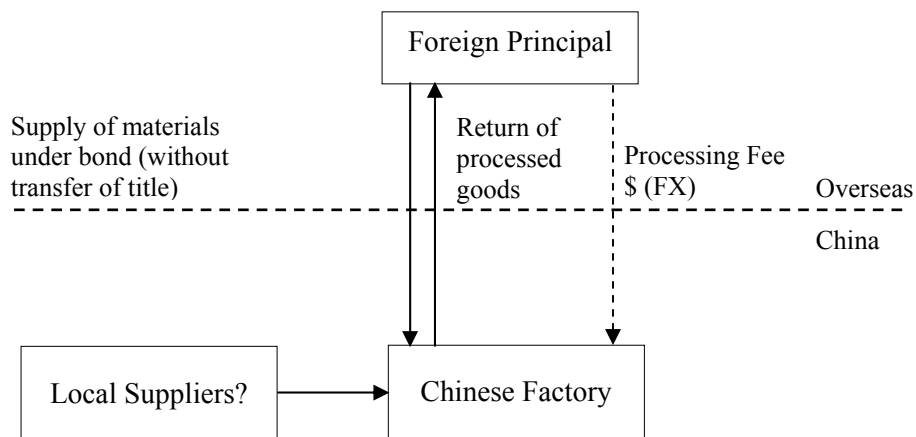
However, starting from January 1, 2008, the tax incentives for manufacturing FIEs and EOE’s will be repealed, subject to the grandfathering provisions available for entities established prior to March 16, 2007. If the WFOE has considerable profits, it will face a significant tax burden.

Use of contract manufacturing structures can help to shift functions and risks outside of China such that the profits may potentially be booked in an entity outside China. Hopefully, this would be in a jurisdiction with a lower tax rate, thus reducing the overall tax burden of the group.

Two Main Forms of Contract Manufacturing Arrangement

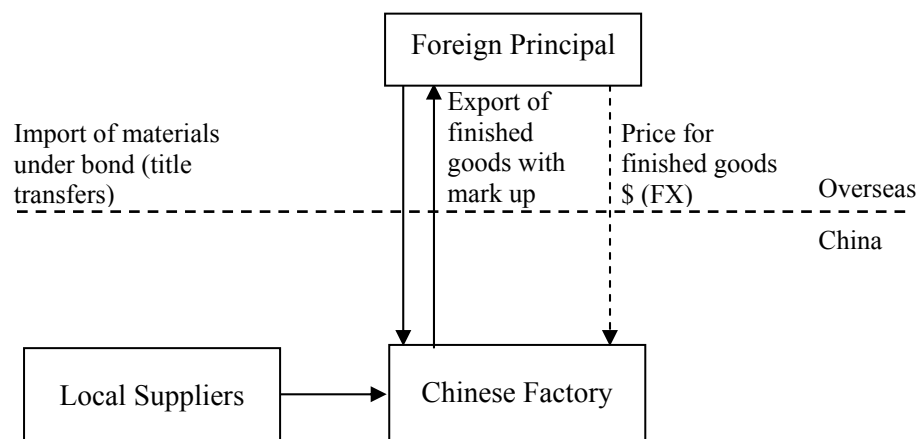
There are two main forms of contract manufacturing in China:

Figure 2 - Consignment Manufacturing (来料加工)



- Toll manufacturing (*lai liao jiagong*): a foreign company ships components to a PRC enterprise. This PRC enterprise is authorized to engage in toll manufacturing business on a customs duty and VAT-free basis, provided that the finished goods are all exported after processing. The foreign company retains title to the components throughout the whole period. Under this arrangement, the PRC authorized enterprise would be remunerated by way of processing fees paid by the foreign company.

Figure 3 - Turnkey Manufacturing (进料加工)



- Turnkey manufacturing (*jin liao jiagong*): the PRC enterprise actually purchases and obtains title to the imported raw materials from the foreign company, and sells the finished goods back to the original foreign company or to another overseas company. Under this

arrangement, the PRC enterprise would be remunerated by way of the gross margin it receives on the finished goods as opposed to earning a processing fee.

The essential difference between the two is that, in a toll manufacturing operation, the foreign party retains title to the imported materials and processed products at all stages of the operation. Any revenue earned from the sale of the finished products remains with the foreign party. Remuneration for the Chinese factory takes the form of a fixed processing fee. Under a turnkey manufacturing arrangement, the Chinese processing entity obtains title to the imported materials and retains title until the processed goods are exported. Thus, the turnkey manufacturer earns its profits from the margin on the sale of the processed goods to the foreign party.

Benefits of Contract Manufacturing Arrangements

There are various benefits associated with carrying out contract manufacturing arrangements in the PRC. These include the following:

- Lower profit margin in China and therefore lower EIT cost. This is because the PRC factory does processing only. Other risks and functions, e.g., sourcing, marketing, sales, inventory risk and credit risk are carried out or borne by the foreign principal. Therefore, more profit can be booked offshore.
- Exemption from customs duty and import VAT on all imported parts, materials and equipment. Normally, imported goods are subject to customs duty and import VAT. However, all parts, materials and equipment imported for contract manufacturing arrangements are bonded goods and therefore are not subject to customs duty or import VAT.
- Elimination or reduction of export VAT “leakage” on finished goods exported from China. Normally, when a PRC company purchases materials from the domestic market, it pays 17% VAT. Upon exporting the finished goods, it can claim a refund, which is often less than the full amount of such “input” VAT. Therefore, there is a VAT “leakage”. Contract manufacturing arrangements can reduce the leakage because most of the materials used are imported. If the manufacture must purchase materials in China, it can round-trip the domestic materials through bonded logistic zones as imported materials. In this arrangement, the foreign principal purchases the materials from the PRC suppliers, and the materials will be first shipped to a bonded logistics zone. Goods shipped into a bonded logistic zone will be considered exported out of China for both customs and tax purposes. Then the materials can be shipped from the bonded logistic zones to the PRC factory as imported goods.

Potential Issues Associated with Contract Manufacturing Arrangements

Although there are many benefits associated with contract manufacturing arrangements, foreign investors who would like to use this approach as part of a tax minimization strategy should note the following potential issues.

First, in order to encourage foreign investors to move more value-added functions to China, some localities are reluctant to approve contract manufacturing arrangements. According to our experience, some local authorities have been more willing to give approval to FIEs wanting to undertake turnkey manufacturing arrangements rather than to those wishing to enter into toll manufacturing arrangements. Therefore, when an existing manufacturing WFOE wants to change its business model to contract manufacturing, it may encounter some difficulties in getting approval, especially if it seeks to enter into a toll manufacturing arrangement. On the other hand, if a foreign investor seeks to set up a new contract manufacturing entity in one of the Export Processing Zones designated for contract manufacturing operations, it may not encounter any problem in obtaining approval.

Further, the tax authorities will anticipate that many FIEs will adopt different tax minimization strategies due to the increased tax burden under the New EIT Law. Therefore, all tax minimization structures will likely be subjected to closer scrutiny by the tax authorities. For example, the tax authorities may question the reasonableness of the level of processing fees from a transfer pricing perspective, or seek to tax the profit of the foreign principal on permanent establishment (“PE”) grounds. If the foreign principal is a company located in a treaty country, it should not have a PE in China simply by entering into a contract manufacturing contract with a PRC entity. However, if the foreign principal is actively involved in the management of the PRC factory or the quality control process, it may be deemed to have a PE in China and the profits attributable to the PE will be subject to PRC taxation.

Finally, simple contract manufacturing arrangements will work only if the finished products are targeted at offshore markets, because one of the requirements of contract manufacturing arrangements is that all the finished products should be exported. If most of the finished products will be sold in China, more sophisticated planning involving the using of bonded logistic zones is necessary. Under such structures, the finished products will first be shipped into a bonded logistic zone and be deemed to be exported for tax and customs purposes to satisfy this requirement. The products can then be "imported" again to China and sold to PRC customers.

There are a myriad of other, more detailed concerns with such structures, but these are the types of issues that businesses ought to be considering when commencing a more detailed analysis of such approaches.

3.2 Use of Limited Risk/Function Sales/Procurement Agent Structures

China has become a major market for many MNCs to both sell into and from which to procure products and materials. In order to better serve the Chinese market, a local presence is normally a necessity. Therefore, many MNCs have, or are considering to, set up distribution WFOEs in China. The low risk/function commission agent structure discussed below may reduce the reportable profits of the PRC operation and therefore minimize the overall tax costs, by shifting risks and functions to an offshore principal.

Figure 4 - Cost-Plus Sales Structure

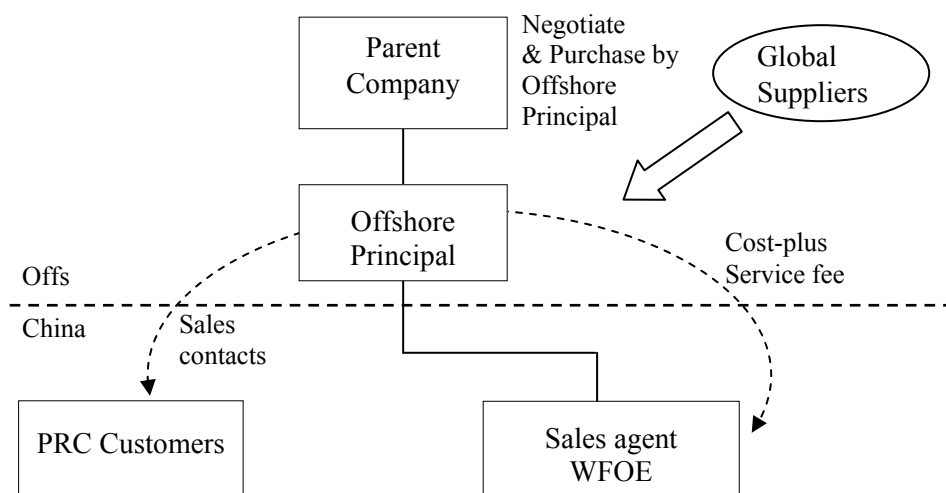
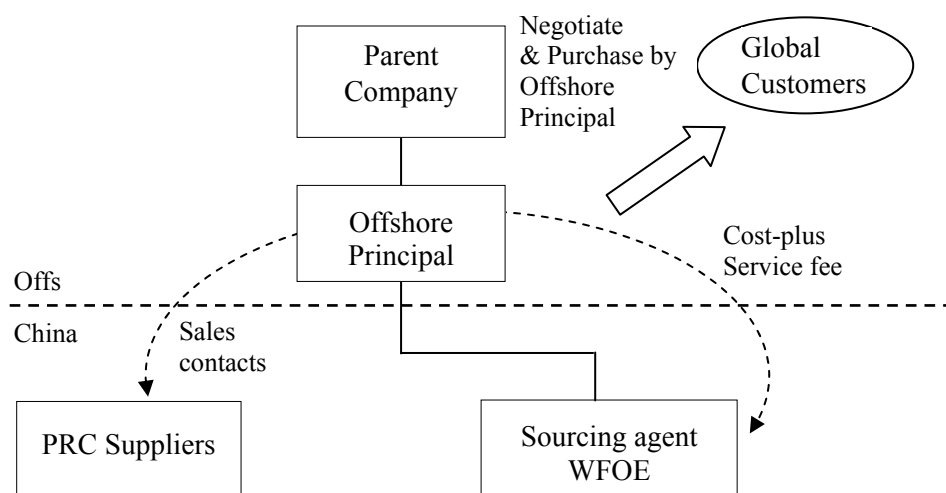


Figure 5 - Cost-Plus Sourcing Structure



As can be seen in Figure 4 and 5, the concept is to have a limited risk onshore entity structured as a service provider to, or agent of, the offshore principal.

Normally, if a foreign company has a distribution WFOE in China, it will sell products to the WFOE and the WFOE in turn will re-sell the products to PRC customers. To change this arrangement, the foreign company will need to contract directly with the PRC customers or suppliers. The WFOE will only provide sales/procurement agency services, e.g., marketing, identifying customers and certifying suppliers, but it will not take title to the goods. With the recent liberalization of foreign trade rights, more PRC companies can deal directly with foreign suppliers and customers in terms of currency and customs clearance. Therefore, these types of arrangements have the potential to be used more broadly.

Benefits of a Commission Agent Arrangement

Under a low-risk commission agent arrangement, because the foreign company will bear most of the risks, the WFOE commission agent will earn only a limited agency fee (perhaps a percentage of the sales price, or a cost-plus fee). This potentially allows for more of the profit to be kept in the hands of the offshore principal in Hong Kong, Singapore or another low-tax jurisdiction. The same concept can be used when sourcing goods from China.

The WFOE may also provide after-sales services and technical support to PRC customers. If the relevant product is a high tech product, the FIE may qualify as an HNTE if its main revenue is derived from the provision of high tech related services. The FIE may then be able to enjoy the corresponding beneficial tax rate under the New EIT Law. Although this would be the case under the current income tax rules, it is possible that an intellectual property ownership requirement will be introduced under the implementing rules for the New EIT Law.

Potential Issues Associated with the Commission Agent Arrangement

Similar to contract manufacturing arrangements, low risk/function WFOEs will reduce the profit margin of the PRC operation and therefore will likely result in additional scrutiny from the tax authorities.

The first major concern is from a transfer pricing perspective. The New EIT Law imposes late payment interest on transfer pricing adjustments. A set of more detailed transfer pricing documentation rules is expected to be issued this year or sometime in 2008. Therefore, MNCs need to conduct internal transfer pricing studies and prepare adequate supporting documentation for their transfer pricing practices. The following arguments can be used to justify a low profit margin for the PRC commission agent:

- the foreign principal performs most of the administrative functions;
- the foreign principal bears relevant risks, e.g. market fluctuation risk, collection risk and inventory risk;
- the foreign principal owns the intellectual property rights;
- the foreign principal has built up the global customer pool; and
- the foreign principal handles the logistics of the sales, e.g. shipping and handling.

Another important risk for the foreign principal is the PE risk in China. Historically, the PRC tax authorities have not been aggressive in terms of enforcing PE rules. However, the SAT has shown a trend towards stricter PE enforcement.

For instance, the SAT issued Circular *Guo Shui Han [2006] No. 970* on October 17, 2006 targeting foreign companies doing business through dependent agents. The company concerned was a Hong Kong company that did not have any substantial operations in Hong Kong. Its main business was to sell products to PRC customers and provide relevant technical services. It had a subsidiary WFOE in China which negotiated and signed contracts with

PRC customers in the name of the Hong Kong company. The WFOE also provided technical services. The SAT held that the Hong Kong company had a PE in China in this situation and that all its profits should be taxed in China.

Therefore, foreign companies who wish to take advantage of this model should put real substance in the offshore principal entity and carefully monitor and limit the functions of the onshore WFOE. A simple shell entity with no substance would potentially raise concerns.

3.3 Potential Risks

In addition to the case-by-case risks mentioned above, as described in part 1.4 above, the New EIT Law introduced a general anti-avoidance rule. It is still unclear whether the PRC tax authorities will attack treaty tax planning or other minimization strategies under the general anti-avoidance rule. Thus, where possible, the focus should be to look at the business purpose to any transaction and attempt to frame any transaction properly.

4. Conclusion

In China's changing tax landscape, foreign investors face many new changes but at the same time have new opportunities. Effective tax planning requires careful consideration of both tax and commercial factors. Careful reconsideration of current business structures is required at this critical stage to ensure continuous success of the PRC operation of MNCs.

Although there are some short-term opportunities in the marketplace, an effective China strategy will require a long-term focus that will truly move functions and risks outside of China within a proper treaty context.