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Long-Awaited Detailed Implementing Rules Finally Issued for New EIT Law

On December 11, 2007, the State Council promulgated the long-awaited Detailed Implementing Rules (“DIR”) of PRC Enterprise Income Tax Law (“EIT Law”). The DIR sets forth details on the definition of numerous terms, interpretations and specific application of various provisions prescribed by the EIT Law issued earlier this year, on March 16, 2007. Like the EIT Law, the DIR will become effective on January 1, 2008. We have outlined some of the key provisions of the DIR that are likely to be most important to foreign enterprises and foreign invested enterprises (“FIEs”).

We plan to issue a more detailed structuring alert in January once some additional clarity has been achieved on certain aspects of the DIR.

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Resident enterprises:

- Resident enterprises will be subject to PRC Enterprise Income Tax (“EIT”) on their worldwide income. A foreign enterprise with effective management in China will be considered as a resident enterprise. Effective management is defined to be the overall management and control of the production, business, employees, finance and assets of an enterprise.
- The broad meaning of resident enterprises is likely to impact PRC nationals with round-trip structures where they set-up an offshore vehicle to re-invest in China. It may impact MNCs with offshore holding vehicles as well.

Income recognition rules:

- Dividends should be recognized as income at the time when the distributing enterprise declares a profit distribution. The question is whether a foreign investor could still be exempted from dividend withholding tax if an FIE passes a board resolution before December 31, 2007 declaring a dividend distribution out of 2007 profits.
- Interest, rental and royalty incomes should be recognized as incomes at the time when payments are due according to the relevant contracts.

Sourcing rules:

- Income from sale of goods is sourced to where the transaction takes place; however, it is not further defined at which point a transaction is considered to have taken place, e.g., title passage, negotiation or signing of contracts.
- Income from provision of services is sourced to where the services are rendered.
- Income from transfer of equity assets is sourced to where the transferred enterprise is located.
- Dividend income is sourced to where the distributing enterprise is located.
- Interest, rental, and royalty incomes are sourced to where the enterprise, which actually pays or bears the expenses, is located.

Deductible expenses:

- Interest expenses paid on bank loans can be deducted.
- Interest expenses on loans from non-financial institutional lenders are deductible up to normal interest rate offered by commercial banks.
- Employee welfare expenses are deductible up to 14% of the total remuneration expense of the enterprise.
- Eligible advertising and business promotion expenses are deductible up to 15% of the enterprise's annual sales revenue. The excess can be carried forward and deducted in future years.
- Meals and entertainment expenses are deductible up to 60% of the expenses incurred, subject to a cap at 0.5% of annual sales revenue of the enterprise.
- Purchased goodwill can be deducted at the time the enterprise transfers its entire business or liquidates. (It is not entirely clear whether purchased goodwill is amortizable in the 10-year period as an intangible asset.)

Non-deductible expenses:

- Inter-company management fees, intra-company rental charges and royalty payments amongst business units, and intra-company interest expenses amongst business units of a non-financial institutions are not deductible.
- Sponsorship expenses that are not in the nature of advertisement are not deductible.

Withholding tax

- The withholding tax rate on PRC-source passive income such as dividends, capital gains, interest, rents, and royalties is reduced from 20% to 10% as stated in the EIT Law.

Corporate restructuring:

- Gains or losses from corporate restructuring transactions should be recognized at the time when the transaction occurs. The tax basis of the relevant assets should be revised based on the transfer price, unless otherwise prescribed by the Ministry of Finance (“MOF”) and the State Administration of Taxation (“SAT”).
- Separate circulars are expected to be issued to further clarify tax treatment of group restructuring. Therefore, it is still unclear whether the current tax-free transfer of shares prescribed by Circular Guoshuihan [1997] No. 207 will survive after 2007.

Tax incentives:

- Tax exemption is available on dividend income of a resident enterprise derived from direct equity investment in another unlisted resident enterprise.
- Tax exemption is also available on dividend income of a resident enterprise derived from stock of listed companies that are held for more than 12 months.
- 3 + 3 tax holiday (i.e., 3 years of tax exemption plus 3 years of 50% tax reduction) starting from the tax year when production revenue is generated is available for the following projects:
 - income derived from an investment in or the operation of infrastructure construction projects eligible for key support from the state;
 - income derived from environmental protection, energy-saving or water conservation projects that meet the relevant conditions.

Any unused tax holidays on transfer of the project may be utilized by transferee.

- 10% of the total investment on special equipment for environmental protection, energy-saving, water conservation and enhanced protection safety can be applied as a credit by the enterprise to offset its tax payable. Any unutilized amount can be carried forward for 5 years. However, equipment disposed of or leased out within 5 years will have the credit re-captured.
- For income from qualified technology transfers by resident enterprises, the first RMB 5 million is exempt from tax, while the amount over that limit may enjoy a 50% reduction in EIT.

- Super deduction:
 - An enterprise is allowed to deduct 150% of its R&D expenditure incurred on development of new technology, new products and new processes if intellectual property (“IP”) has not been created. Otherwise, 150% of costs of the IP can be amortized.
 - An enterprise is allowed to deduct 200% of its disabled employees’ wages.
- Qualified high new technology enterprise (“HNTE”)
 - HNTE enjoys a concessionary tax rate of 15% under the EIT Law.
 - The DIR expands on the requirement to qualify as a HNTE. Generally, ownership of core IP/technology in China is required. But the detailed requirements to qualify as HNTEs are left to be further defined by the Ministry of Science and Technology, MOF and SAT.
 - It is still unclear as to whether economic ownership of the IP/technology, as opposed to legal ownership, will suffice.
- A venture capital enterprise that makes equity investment in unlisted medium and small scale qualified HNTEs is allowed to deduct 70% of its equity investment against annual taxable income starting from the second year, provided that the investor has held the investment for at least two years.

Transfer Pricing Rules

- The DIR does not stipulate timing to submit contemporary transfer pricing documents. Instead, it states that transfer pricing documentation must be submitted by a taxpayer within the time frame imposed by the in-charge tax authority.
- Cost sharing agreements and other documents are required to be submitted to the in-charge tax authorities upon request.
- Related parties loans for the purpose of transfer pricing are defined to include:
 - debt investment made by a related party through an unrelated third party;
 - debt investment made by an unrelated third party, for which a related party has provided a guarantee and is jointly and severally liable; or
 - any other debt investment indirectly made by related parties.
- Interest expenses paid to a related party in excess of the prescribed debt-equity ratio are not deductible. The detailed debt-equity ratio

for loans between related parties will be prescribed jointly by MOF and SAT.

Anti-avoidance tax adjustments:

- Any arrangement lacking reasonable commercial purposes which results in a reduction of taxable revenue or income may be subject to special tax adjustment made by tax authorities.
 - Lack of reasonable commercial purpose is defined to capture arrangements where the primary purpose is to achieve tax effects such as tax reduction, exemption or deferral of tax payments.
- Underpaid tax resulting from tax adjustments will be subject to an interest levy as follows:
 - 5 basis points will be added to the People's Bank of China ("PBOC") interest rate applicable in the year of the tax liability and for the same period as the late payment period.
 - No basis points will be added to the PBOC interest rate if the enterprise has prepared, maintained and provided documentation.
- Statute of limitation
 - The limitation period for tax adjustments is 10 years.

Controlled foreign companies ("CFCs")

- A Chinese resident corporate shareholder is subject to tax on undeclared profits kept without a business need by a CFC incorporated in a jurisdiction with a tax rate obviously lower than that of China. For this purpose, there will be attribution where the effective tax burden of the CFC is lower than 12.5%.
- CFCs refer to:
 - Foreign enterprises ("FE") where each resident enterprise or individual directly or indirectly holds at least 10% voting shares of the FE, and jointly owns more than 50% shares; or
 - Any other situations under which the resident enterprise or person has actual control over the FE in relation to capital, business operation, purchase and sale.