

China's New Corporate Income Tax Law

Leveling the playing field for domestic and foreign enterprises

I. BACKGROUND

One of the attractive points for foreign companies willing to invest in China has been the reduced tax rates and preferential treatment bestowed upon them by the Chinese government. Foreign investors typically enjoyed corporate income tax rates between 10-24% and were eligible for tax exemption and rate reductions during their first five years of profitable operation.

However, on 16 March 2007 China's People's Congress passed a new Corporate Income Tax Law unifying the tax treatment of domestic and foreign enterprises. The new Law, effective 1 January 2008, puts an **end to the decades of preferential treatment** that foreign investors have received.

One of the most important changes in China's corporate and foreign investment policy in the last twenty years, the Law is in line with the recent government policy of "improving the level and quality of foreign investment". The Law is also representative of China's intended shift away from a predominantly export-driven economy and its greater emphasis on domestic consumption and demand.

This article aims to explain those articles of the new Corporate Income Tax Law most relevant to foreign direct investment and present InterChina's suggestions on dealing with the expected changes.

II. NEW CORPORATE INCOME TAX LAW

The new Law will unify the corporate income tax for all enterprises operating in mainland China at 25%. All types of companies, regardless of type, ownership, or location, will be subject to the same taxable bases, classifications, incentives, and deduction criteria.

The new tax rate eliminates the differences between taxation on Chinese companies and foreign invested companies: Chinese companies will enjoy an 8%-point reduction (current tax rate is 33%), while foreign invested companies could face increases as high as 15%-points (from 10% to 25%). Tax holidays and rate reductions will no longer be available exclusively for foreign enterprises and deduction limitations on domestic companies have been eliminated

The new Corporate Income Tax Law will take effect **on 1 January 2008. FIEs established before that date will not face an immediate tax rate increase**, but instead will have a transition period of five years. Although details have yet to be finalized, existing companies are expected to see a 2% per year rise in their tax burdens following the introduction of the law. Foreign invested enterprises eligible for tax exemptions and reductions will continue

enjoying this status until the five-year period expires. However, the first year of tax exemption must be no later than 2008, thus eliminating the possibility of accumulating losses and having the tax exemption period start after this date.

Regarding tax incentives, the new law entails a shift from a location and ownership-based approach to a more industry-focused incentive system. Previous benefits available to manufacturing enterprises and specific regions have been eliminated and a tentative list of encouraged projects has been introduced. More specifically, the new law reflects the government's focus on investments in R&D and advanced technology and major infrastructure, environmental, and agricultural projects.

The **most relevant tax incentives** under the new Law are:

- 15% tax rate for all qualified high/new technology companies, regardless of location within or outside of a High Tech Industrial Zone.
- 20% tax rate for qualified small and thin-profit companies.
- 150% R&D expense deduction for development of new technology, new products, and new processes.

In addition, certain incentives will continue to exist for special sectors, such as agriculture and fishery, and for "Encouraged Enterprises" located in the Western Regions.

III. IMPACT

In general the new law will increase the tax burden of foreign invested enterprises and decrease that of domestic enterprises. China's tax bureau has estimated that the new measures will cut taxes on domestic enterprises by RMB 17 billion while increasing foreign tax revenues by RMB 5 billion. Detailed implementation rules, the "Method of Execution of the Corporate Income Tax Law", are expected to be released later this year.

Over the long run the new regulations will create a level playing field for all enterprises: tax collection will be enhanced for Chinese companies thanks to a more stringent and transparent collection system and foreign enterprises will be forced to compete based upon their competitiveness rather than tax advantages. The shift away from a geographically based incentive system will create more efficient resource allocation and raise the importance given to operating factors in site selection. The new Law also signals a clear shift in China's foreign direct investment orientation. The higher tax rate for foreign investors will be used to screen out smaller investments in low technology projects and encourage those necessary for China's long-term development.

In the medium term, China is likely to see four significant business changes: (i) a shift in low added value investment flows to western China or neighboring countries; (ii) increased competition as local players translate newly granted benefits into lower product pricing; (iii) an upgrading of foreign investment towards more capital-intensive industries (increased focus on the production process and cost optimization); and (iv) a boom in consumption due to more active and competitive pricing.

Overall, the enactment of the unified tax rate should be seen as a positive development and

indicative of China's transition towards a more rule-based economy. Its implementation will result in a more transparent and efficient marketplace and is essential for China's continued economic growth. The overall impact on foreign investment is likely to be limited as tax issues are no longer a primary driver and China's economic fundamentals remain strong.

IV. ICC RECOMMENDATIONS

The new law entails significant changes that must be addressed and evaluated by all enterprises operating in China.

As implementation regulations are issued, companies should review their status and consider whether they qualify for the new tax incentives or if a restructuring would enable them to qualify at least a portion of their activities. Investors considering new projects should do the same regarding their planned operations. Companies should also adjust their business and financial forecasts to reflect accurately the new changes demanded by the law.

If possible, InterChina encourages those investors currently considering investments to register their companies before the new Law's enactment in order to obtain the tax holidays and incentives of the current system.

Even though the new Law represents a clear change of focus in tax incentives, from geographic incentives concentrated in industrial zones towards preferential treatment for specific sectors, projects, and products, this does not mean future foreign investment should be located outside of industrial zones. Industrial zones will continue to offer a better operational and government environment, more policy transparency, and superior infrastructure when compared with surrounding areas. For this reason, InterChina sees industrial zones playing a sustained role in facilitating China's foreign direct investment.