

NEWSLETTER

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This newsletter offers a brief introduction to the **New Enterprise Income Tax Law**, which became effective on January 1st, 2008.

CONTACT

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Disclaimer:

This newsletter is intended to provide general information regarding recent developments in China.

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SECTION ONE GENERAL INTRODUCTION

The New Enterprise Income Tax Law (the new law) was enacted by the Tenth National People's Congress on March 16th, 2007. The new law became effective on January 1st, 2008. Regulations regarding details for the implementation of the new law were issued on December 11th, 2007.

The most significant change for the Chinese income tax system is the consolidation of the Enterprise Income Tax Law (applicable for domestic Chinese enterprises) and the Foreign Enterprise Income Tax Law (applicable for foreign enterprises and foreign-invested enterprises, or FIEs). Also, most tax incentives that applied exclusively to FIEs have been revoked.

In the sections that follow, please note that the important changes discussed in the following sections have been influenced by the main objectives of income tax reform, which aim to...

- Simplify the tax system, broaden the tax base, lower tax rates and improve tax collection procedures;
- Make the tax burden equal for domestic and foreign-invested companies;
- Assign tax incentives based on industry, rather than region; and
- Focus on developing industries that are environmentally friendly, energy-saving, or conducive to safety in the workplace, rather than export-oriented industries.

SECTION TWO

TAX PAYERS AND TAX RATES

1. TAX PAYER DEFINITION

The new law changes the definition for “tax resident” in order to broaden the tax base.

According to the new law, enterprises established in China *as well as* foreign enterprises that perform effective management and control operations within China are now recognized as “China tax residents” and must pay income taxes on their worldwide income. Enterprises that are neither established in China nor performing effective management and control operations within China are recognized as “Non-China tax residents” and shall only pay income taxes for income sourced in China.

2. NEW TAX RATE

The base income tax rate of the new law is 25%, which is down from the 33% rate set by previous regulations. Also, a preferential tax rate of 20% is granted to small and thin-profit enterprises that meet the following criteria:

1) Manufacturing Companies:

- Annual taxable income is no more than 300 thousands RMB ;
- Total employee headcount is no more than 100; and
- Total value of assets exceeds 30 million RMB.

2) Non-Manufacturing Companies:

- Annual taxable income is no more than 300 thousand RMB ;
- Total employee headcount is no more than 80; and
- Total value of assets exceeds 10 millions RMB.

SECTION THREE

KEY CHANGES FOR TAX INCENTIVES

1. REMOVED TAX INCENTIVES

In order to make the tax burden equal for domestic and foreign-invested companies, most tax incentives that applied exclusively to FIEs have been removed.

The revoked tax incentives once granted to FIEs by previous laws can be summarized as:

- A “two-year tax exemption and three-year 50% tax rate reduction” tax holiday for FIEs involved in the manufacturing industry;
- An extended “50% tax rate reduction” tax holiday for export-oriented FIEs; and
- 15% or 24% preferential tax rate for FIEs established in special economic zones.

2. RETAINED TAX INCENTIVES

Original tax incentives designed to encourage the establishment of industries and enterprises in Western China have been retained. These retained incentives apply to:

- Investments in infrastructure, agriculture, forestry, livestock, farming, and fishing; or
- Investments in Western China for “encouraged industries,” which are specified in a Chinese government-issued catalogue.

Key Changes for Tax Incentives Continued...

3. NEW TAX INCENTIVES

In the previous system, incentives were provided according to “regional orientation,” where each region selectively chose which industries were eligible to receive tax incentives. The new slogan describing the revised system as “industry-based, supplemented by regional preferences” represents a transition from the old region-based incentives to the new industry-based incentives.

As a result, several tax incentives have been established by the new law to support encouraged industries:

- High-tech entities throughout China are granted a preferential tax rate of 15%;
- High-tech entities newly established in special economic zones and the Shanghai Pudong New Area are granted a tax holiday of a “two-year exemption and three-year 50% tax rate reduction”;
- Tax credits are awarded for equipment investments to be used in projects that are environmentally friendly, energy-saving, or conducive to safety in the workplace;
- Tax deductions are awarded for venture capital that will be engaged in start-up investments for encouraged industries; and
- Direct tax exemptions and rate reductions are provided for labor service enterprises and welfare enterprises.

SECTION FOUR

GRANDFATHER RULE FOR REMOVED TAX INCENTIVES

Many foreign companies have been granted tax incentives that are removed by the new law. The new law, however, provides a “grandfather rule” to protect the existing incentives for already-approved projects over the course of the next five years (from 2008 through to 2012).

- FIEs that started their tax holiday before the effective date of the new tax law (January 1st, 2008) are allowed to enjoy the remainder of their holiday;
- FIEs that (1) were established before the new law was released, (2) qualified for a tax holiday under the old tax law, and (3) did not start the holiday before January 1, 2008, will start their tax holiday on the effective date of the new law;
- FIEs currently enjoying 15% or 24% preferential tax rates are granted a 5-year transition period before moving up to the 25% rate.