

# A Summary of Enterprises Income Tax Law of the People's Republic of China

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Foreign invested enterprises (“FIE”) and domestic enterprises<sup>1</sup> were subject to different income tax regulations and tax rates in China in the past. For example, as compared with domestic enterprises, FIEs generally were eligible for a lower income tax rate and more tax deductions and exemptions. With the effectiveness of the *Enterprise Income Tax Law of the People's Republic of China* (“Tax Law”) and the *Implementing Rules of the Enterprise Income Tax Law of the People's Republic of China* (“Implementing Rules”) (collectively referred to as the “New Tax Laws”) as of January 1, 2008, however, the above situation has materially changed. As compared to previous tax laws, FIEs and domestic enterprises are no longer used as labels for different enterprise income tax payers, and they are now both subject to the same income tax law and same tax treatment. The following is a summary of the New Tax Laws.

## WHO PAYS THE ENTERPRISE INCOME TAX?

Under the New Tax Laws, resident enterprises and non-resident enterprises both pay enterprise income tax for their taxable income in China. Resident enterprise refers to an enterprise, public institute, social union or other organization receiving income, which is legally incorporated in China or which is incorporated under foreign law but has its actual management in China. Actual management means a department which exercises overall management and control over the manufacturing and operations, employees, finance and property of the enterprise. Non-resident enterprise refers to an enterprise or other organization receiving income, which is incorporated under foreign law without actual management in China but has an institution or premise<sup>2</sup> in China or receives income derived from or accruing in China. The above institution or premise means an institution or premise engages in manufacturing or operation in China, including:

- (1) Administrative department, operation department and affairs office;
- (2) Factory, farm and premise of mining;
- (3) Premise for providing service;
- (4) Premise for engaging in construction, equipment, assembly, repair or prospecting; and
- (5) Other institution or premise engages in manufacture or operation.

Where a non-resident enterprise engages an agent for the activities of manufacturing or operations, including authorizing an individual or entity to execute contracts, or to deposit or deliver goods frequently for it, such agent shall be deemed the institution or premise within China of the non-resident enterprise.

## HOW MUCH TO PAY?

A resident enterprise (both FIE and domestic company) must pay enterprise income tax for its income derived from or accruing both in and outside China. A non-resident enterprise with an institution or premise in China must pay enterprise income tax for both the income derived from or accruing in China received by the institution or premise and the income derived from or accruing outside China with the de facto relationship with the China institution or premise. A non-resident enterprise without a institution or premise in China and a non-resident enterprise with a institution or premise in China but receiving no income outside China with any de facto relationship with such China institution or premise, shall only pay enterprise income tax for the income derived from or accruing in China.

[1] An enterprise incorporated under Chinese law which has no foreign shareholders.

[2] Under current Chinese laws, a foreign company is generally permitted to set up a representative office acting as a contact institution within China, but such representative office can not directly engage in business operations in China. So if a foreign company proposes to do business in China directly, except in some particular circumstances, for example, a foreign financial institution can set up a branch to engage in specified business and certain Sino-foreign contractual joint venture can exist in a form of non-legal person, it is necessary for such foreign company to set up a subsidiary to do business in China. According to our understanding, the term of institution or premise of non-resident enterprise includes the representative office and other non-legal person institution of foreign company. As to the subsidiary of a foreign company, it is a resident enterprise and is not an institution or premise of a non-resident enterprise.

The amount of enterprise income tax payable is calculated according to the following formula pursuant to the Tax Law:

Tax payment = Taxable amount of income \*Applicable enterprise income tax rate-Tax deduction amount - Tax exemption amount.

#### **Taxable Amount of Income**

The taxable amount of income of an enterprise equals the total income of each tax year less deductions for tax-free income, tax-exempt income, all kinds of deductions and permitted amount of losses in previous year(s).

Total income includes both money and non-money forms of income received by an enterprise from all kinds of sources, which includes:

- (1) Income from sale of goods;
- (2) Income from providing services;
- (3) Income from transfer of properties;
- (4) Dividends, bonus and other return of equity investments;
- (5) Interests;
- (6) Rentals;
- (7) Royalties;
- (8) Income from gifts or donations; and
- (9) Other income.

Under the New Tax Laws, the above money forms of income include cash, deposits, receivable amounts, receivable instruments, bond investments to be held until maturity and waiver of debts, etc. Non-money forms of income consist of fixed assets, biological assets, intangible assets, equity investments, inventories, bond investments not to be held until maturity, labor services and relevant interests. Under the New Tax Laws, the non-money form amount of income must be determined based on its market value. The Implementing Rules also further elaborate all kinds of detailed income items with almost a whole section.

#### **Tax Preferences**

The New Tax Laws also provide certain tax preferences for specific income and qualified tax payers, including without limitation tax-free income, tax-exemptible income, tax-deductible income and low tax rate.

The following income is tax-free income:

- (1) Financial allocation;
- (2) Administrative public charge or government fund which is collected pursuant to the law and brought under financial administration;
- (3) Other tax-free income stipulated by the State Council.

The following income is tax-exemptible income:

- (1) Income from the interests of treasury bond issued by the Treasury Department of the State Council;
- (2) Dividend, bonus and other return of equity investment between qualified resident enterprises;
- (3) Dividends, bonus and other return of equity investment received by a non-resident enterprise which has an institution or premise in China from a resident enterprise provided such income has a de facto relationship with the above China institution or premise; and
- (4) Other income received by qualified non-profit organizations.

The following income may be tax-exemptible or tax-deductible income:

- (1) Income from the project of agriculture, forestry, husbandry or fishery;
- (2) Income from the investment and operation of a key public infrastructure project supported by the State;
- (3) Income from a qualified project of environmental protection, energy conservation or water conservation;
- (4) Income from a qualified technology transfer; and
- (5) Income derived from or accruing in China and received by a non-resident enterprise without an institution or premise in China, or by a non-resident enterprise with an institution or premise in China but the above income without any de facto relationship with such China institution or premise.

In accordance with the New Tax Laws, reasonable expenses which are normal and necessary and are directly relating to the enterprise's income and conform to the regular rules of the production and operation and are used in calculating current profits and losses or relevant capital costs, including costs, expenses, taxes, losses and other expenditures, may be deducted when computing the amount of taxable income. The New Tax Laws also specify various items of deduction and corresponding exceptions.

Other than relevant deductions and exemptions of taxable amount of income stipulated in the New Tax Laws, a qualified enterprise is also entitled to a certain preferable enterprise income tax rate as set out below.

### **Enterprise Income Tax Rate**

Under the New Tax Laws, the general rate of enterprise income tax is 25%. A lower tax rate may apply where there is any of the following circumstance:

- (1) The applicable tax rate for income derived from or accruing in China and received by a non-resident enterprise without an institution or premise in China, or by a non-resident enterprise with an institution or premise in China but the above income without any de facto relationship with such China institution or premise, is 10%;
- (2) The applicable tax rate for the following qualified enterprises which engage in non-restricted and non-prohibited business is 20%:
  - (a) An industrial enterprise with annual taxable amount of income less than RMB300,000 and employees fewer than 100 and total asset less than RMB30,000,000, or
  - (b) Other enterprise with annual taxable amount of income less than RMB300,000 and employees fewer than 80 and total asset less than RMB10,000,000.
- (3) The applicable tax rate for a high and new-technology enterprise under the support of the State which owns independent key intellectual properties and conforms to the following conditions is 15%:
  - (a) The products (services) fall within the scope the fields of high and new-technology entitled to the key support of the State;
  - (b) The proportion of research and development expenses in sales revenues is no lower than stipulated criteria;
  - (c) The proportion of the income from high and new-technology products (services) in the total income is no lower than stipulated criteria;
  - (d) The proportion of technicians in the total employees is no lower than stipulated criteria; and
  - (e) Other conditions as stipulated in the measures for the determination of high and new-technology enterprises.

### **Special Adjustment on Tax Payment**

Where the transactions between an enterprise and its affiliates are not arm's length principle transactions, which, as a result, decrease the taxable amounts of income of such enterprise or its affiliates, the tax authority may adjust their taxable amounts of income by reasonable methods. An enterprise may propose the transfer pricing principle and computing method for transactions between itself and its affiliates to the tax authority. The tax authority and such enterprise can agree on advance pricing arrangement after due discussion.

Under the New Tax Laws, if an enterprise, which was incorporated in a country (region) with actual tax responsibilities apparently lower than the general tax rate stipulated by the Tax Law and controlled by a resident enterprise(s) or jointly controlled by a resident enterprise(s) and a China resident individual(s), does not make any dividend or reduces the dividend amount without reasonably operational demand for the cash, the amounts of the dividable profit of such enterprise, which should belong to the resident enterprise(s) if the above dividend was duly made by such enterprise, shall be counted as a part of current period income of the above parent China resident enterprise(s) when computing the taxable income .

### **HOW TO PAY?**

#### **Where to Pay?**

The tax payment place of a resident enterprise shall be the registration place of the enterprise. For a resident enterprise with registration place outside China, the tax payment place of such enterprise shall be the location of the actual management within China. For a non-resident enterprise with an institution or premise in China, where there is any income derived from or accruing in China received by the above China institution or premise or income derived from or accruing outside China but with the de facto relationship with the above China institution or premise, the tax payment place shall be the location of its China institution or premise. If there is more than one institution or premise

within China, such enterprise may choose the location of the major institution or premise as tax payment place to pay the tax on a consolidated basis subject to the approval from competent tax authority. For a non-resident enterprise without an institution or premise in China or a non-resident enterprise with an institution or premise in China but the income received by such enterprise without any de facto relationship with the above China institution or premise, the tax payment place for its income derived from or accruing in China shall be the location of the withholder.

#### **When to Pay?**

The payment amount of enterprise income tax will be computed on a tax year basis. The tax year will be the calendar year. Where an enterprise starts or ends its business in the midst of a tax year, which makes the actual operation period of the above tax year less than 12 months, the initial tax year shall be the actual operation period. Where an enterprise is liquidated, the period during the liquidation year shall be a final tax year.

The enterprise income tax shall be prepaid on a monthly or a quarterly basis. An enterprise shall submit a declaration form of prepaid enterprise income tax and prepay the tax to the competent tax authority within 15 days after each month or quarter. An enterprise shall submit a declaration form of annual enterprise income tax and settle the payable or refundable amount of enterprise income tax within 5 months after the end of each year

#### **Tax Withholding**

Where a non-resident enterprise without an institution or premise in China or a non-resident enterprise with an institution or premise in China but the income received by such enterprise from China has no de facto relationship with the above China institution or premise, receives income derived from or accruing in China, the payer of such income shall withhold the tax. The amount of enterprise income tax payable by such non-resident enterprise shall be withheld from the payment or payment due by the payer when such payer pays or the payment is due. If the withholder does not withhold or can not withhold, such non-resident enterprise shall pay the enterprise income tax at the place of income derived or accruing. If such non-resident enterprise fails to do so, the tax authority can take the tax due payment from other income derived from or accruing in China received by such non-resident enterprise which other payer shall pay.

#### **What happened to Prior Tax Preference?**

Where an enterprise was incorporated before the promulgation of the Tax Law and was eligible for the preference of a lower tax rate under the tax laws or administrative statutes of that time, it may shift to the current tax rate stipulated by the Tax Law step by step within 5 years after the effectiveness of the Tax Law in accordance with the provisions of the State Council. If such an enterprise was entitled to a fixed-term tax preference treatment, it can continue to enjoy such preference treatment until the fixed-term expires after the effectiveness of the Tax Law in accordance with the provisions of the State Council. However, if such enterprise can not enjoy the preference treatment for lack of profit, the term of preference treatment shall be counted from the effectiveness of the Tax Law. According to the *Notice of the State Council on the Implementation of the Transitional Preferential Policies in respect of Enterprise Income Tax* released on December 26, 2007, for an enterprise enjoying a tax rate of 15% under previous tax laws, the applicable tax rate for it in the next five years is 18% in 2008, 20% in 2009, 22% in 2010, 24% in 2011 and 25% in 2012; for an enterprise enjoying a tax rate of 24% under previous tax laws, the applicable tax rate for it is 25% from 2008. Where an enterprise is entitled to the above transitional preferential policies of enterprise tax, such enterprise must compute the amount of taxable income pursuant to the provisions of income and deduction of the New Tax Laws. If the above transitional preferential policies and other preferential policies stipulated in the New Tax Laws are all available for an enterprise, such enterprise can decide the most preferential one to enjoy, but it can not enjoy them in an overlapped way, and such decision can not change once it has been made.

A high and new-technology enterprise specifically supported by the State can enjoy an interim tax preference provided such enterprise is incorporated within the specified geographical areas established by law for developing the foreign economic cooperation and technical exchanges or other areas which implement the special policy of the above specified areas stipulated by the State.

Other encouraged enterprises as determined by the State may enjoy tax preferences of deduction or exemption in accordance with the provisions of the State.

Where there is any difference between the treaties concluded by the Government of People's Republic of China and Governments of foreign countries, the provisions of the treaties shall prevail. So it is advisable for foreign investor to take tax treaties into account when they design the investment structure. For example, if a U.S company invests in China by setting up a Chinese subsidiary directly, as for the dividends distributed by the subsidiary to the company, 10% of the amount of dividends may be withheld as an enterprise tax payment in accordance with the New Tax Laws, which is the same rate as stipulated by the *Treaty on Avoidance of Double Taxation and Prevention of Fiscal Evasion with respect to Taxes on Income between China and U.S.*. In terms of tax rate for the dividends derived from China, as compared to the provisions of the New Tax Laws, there is no preference under such Treaty. So the tax for the dividends paid by a Chinese subsidiary to a U.S investor may be the same as that paid to a Cayman investor, even there is no tax treaty between China and Cayman. However, if a Hong Kong company with a subsidiary in China, based on the *Arrangement on Avoidance of Double Taxation between China and Hong Kong*, the tax rate for dividends paid by the subsidiary to the Hong Kong company will not exceed 5%, which is lower than that as stipulated in the New Tax Laws.

## CONCLUSIONS

Under the New Tax Laws, FIEs and domestic enterprises are now treated the same as resident enterprises. Even a foreign enterprise may be deemed a resident enterprise, if it meets certain conditions stipulated by the New Tax Laws, for example, a foreign company with its actual management in China will be treated as a resident company. Foreign investors, especially foreign investors focusing their business on China market, need to pay more attention to the New Tax Laws and any direct or indirect, actual and potential consequences caused by them. A traditional investment structure with a special purpose enterprise as the parent company incorporated in a tax free or low tax rate jurisdiction may be no longer sufficient for the purpose of tax avoidance or tax deferral under the New Tax Laws. The changes to the provisions on deduction or exemption for taxable income in the New Tax Laws also deserve special attention, which may require the enterprise to rearrange its expense plans in a more reasonable manner.

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