Corporate Taxation System in China

New Enterprise Income Tax Law

As China's significant taxation reform in 2007, the new corporate tax law was issued within the expectations on March 16, 2007 and will become effective from January 1, 2008. A number of tax preferential policies currently granted to foreign invested enterprises (FIEs) will be abolished in the new law. There is no doubt that the new law will result in fundamental changes to the current corporate taxation system as well as the way for multinational companies structuring business in China.

- Definition of Taxpayer

The new law is applicable to both domestic enterprises and FIEs. Taxpayers are classified into two types: Resident Enterprises and Non-Resident Enterprises. The major classification criteria are: (a) the enterprise is established pursuant to the laws of China; (b) the actual place of management is in China. Where either (a) or (b) is met, the enterprise will be classified as Resident Enterprise of China.

- New Enterprise Income Tax Rate

Under the new law, the general tax rate for Resident Enterprises will be reduced from the current 33% to 25%. Small and low-profit enterprise will be entitled to a reduced rate of 20%. High-tech enterprises that approved by the state will be allowed to continue enjoying the preferential 15% rate. However, the definition of small enterprises and high-tech enterprises needs to be further clarified in the future official interpretations.

- Bonus-Deduction of R&D Expenses

The new law continues to allow bonus-deduction for R&D expenses incurred for new technology, new product and new process.

- Accelerated Depreciation of Fixed Assets

The new law allows accelerated depreciation of fixed assets by means of reducing depreciation period or applying accelerated depreciation method due to the reasons like technology upgrading.

- Charitable Donation

Charitable donations can be deducted up to 12% of annual profit. Nevertheless, under current tax law (expires in Dec. 31, 2007), FIEs are allowed to deduct the total amount of actual charitable donations.

- Thin Capitalization Rule

If the debt investment from affiliated parties exceeds the statutory requirement, the interest expense for the exceeded debt investment will be non-deductible for corporate income tax purpose. This is the first time for China to include thin capitalization rule in the enterprise income tax law.

- Cost Sharing Arrangement

The new law leaves some room for enterprises to utilize cost sharing arrangement with affiliated parties. If the enterprise engages in jointly developing/purchasing intangible assets or providing/accepting services with its affiliated party, the relevant costs should be allocated between the affiliated parties at arm's length.

- Transfer Pricing Rule

Basic transfer pricing documentation is required to file with in-charge tax authority. The transactions between affiliated parties should be carried out at arm's length; otherwise the tax authority is empowered to adjust the under-reported taxable income by a reasonable method. In China, entities will be regarded as affiliated parties if there is a direct or indirect 25% ownership between the entities or by the same 3rd party or other kinds of substantial control.

- Grandfathering Rule

A 5-year grandfathering period will be provided to the FIEs for the preferential tax rate and tax holiday. It is expected that more tax preferential policies will be grandfathered for qualified high-tech enterprises which are newly established in the designated special zones. However, the details need to be further clarified in the future official interpretations.

- Withholding Tax

Under the new law, if the Non-Resident Enterprises have no establishment in China but earn China-sourced income, or the Non-Resident Enterprises has establishment in China but its China-sourced income is not related to its Chinese establishment, such China-sourced income will be subject to PRC withholding tax at a statutory tax rate of 20%.

Currently, interest, rental, royalty and other income (e.g. capital gains) obtained by foreign enterprises are taxed at a reduced 10% rate. And China-sourced profit obtained by foreign enterprises is exempt from withholding tax.

Even though it is still uncertain whether these preferential policies in withholding tax will be retained in the Detailed Rule and Regulation of the new law, withholding tax rate can be reduced by planning with favorable tax treaties.

Other Significant Tax

- Value-Added Tax

Value-added Tax (VAT) is a turnover tax in China levied on the businesses including sales of goods in China, provision of processing, repair or replacement service within China, and importation of goods into China. There are two types of VAT taxpayers, general VAT taxpayer and small-scale VAT taxpayer, which are classified mainly based on the scale of annual sales. The basic VAT rate for general VAT taxpayer is 17%. General VAT taxpayer can be eligible for the claim of input VAT credit against output VAT. Hence, VAT for normal domestic sales does not hit the profit & loss of the general VAT taxpayers.

Export is zero-rated in China. Furthermore, an export VAT refund system is designed to relieve the input VAT of the exported goods incurred earlier in the supply chain. The export refund rates include 0%, 5%, 8%, 11%, 13% and 17%, which are determined by the HS code of the products. Where the export refund rate is lower than the applicable VAT rate, there will generate a non-refundable and non-creditable VAT which results to be an absolute cost to the export enterprises. In case the export refund rate is 0%, the export sales will even be deemed as domestic sales and thus be subject to output VAT.

- Business Tax

Business Tax (BT) is a turnover tax as well in China which is levied on the businesses including the provision of services (other than VAT taxable services), the transfer of intangible assets and the sale of real estate properties in China. BT and VAT are mutually exclusive. The tax rates of BT range from 3% to 20% for different taxable items. The most common rate is 5% which is applicable to services, rental, transfer of intangibles and immovable assets, etc.

- Consumption Tax

Consumption Tax (CT) is a turnover tax as well in China which is levied at either the point of manufacturing, processing, importing or sale of 14 categories of consumable goods, including tobacco, alcoholic drink, cosmetics, jewelry, fireworks, gasoline, tires, motorcycles, automobiles, golf balls and instruments, luxury watches, yachts, disposable wooden chopsticks and solid wood floor boards. The tax basis for CT can be the sales price or sales volume, or a combination of price and volume, which varies to different taxable items. Consumption tax rates range from 3% to 45%. CT generally can be refunded or exempted at the point of export.

- Individual Income Tax

Individual Income Tax (IIT) is levied on the income of salary, service, royalty, interest, dividend, rental, transfer of property, etc. Salaries are taxed at progressive rates ranging from 5% to 45%. Service income is also taxed at progressive rates ranging from 20% to 40%. Royalty, interest, dividend, rental and transfer of property are all taxed at a flat rate of 20%.

IIT taxpayers are classified into two types: tax resident and non-tax resident. Tax residents include China-domiciled individuals and non China-domiciled individuals but stayed in China for one full year and above. Tax residents are taxed on world-wide income; whereas non-tax residents are taxed on China-sourced income only.

Expatriates are entitled to a number of tax exemptions on different kinds of allowances and expenses, such like housing allowance, meal and laundry allowance, relocation expense, language training expense, home leave expense, etc. Proper planning on the remuneration package and timing of assignment can result in a minimized PRC IIT liability for expatriates.