

## PRC Tax

### China Enterprise Tax Reform Series

#### Tax Incentive Developments

Guidance in this Chinese post-tax reform period has been coming in fits and starts. While some of the developments have represented unexpectedly good news for many investors, many would have appreciated earlier announcement of these developments.

So what's new?

- Exemption from 10% dividend withholding tax when pre-2008 earnings are distributed
- Refunds for reinvestment of profits
- Prior incentives allowed "grandfathering" transition benefits
- Final phase-in "grandfathered" tax rates and adjusted phase-in tax rates for companies qualified for "grandfathering" of both a "2+3-type" incentive and the prior 15% incentive rate
- 2008 tax rate to be used by companies that held high and new-tech status in 2007
- 2007 Tax Returns and Settlement Arrangements
- Continued application of certain interest and royalty withholding exemptions
- Effect of post-2007 disqualification on certain pre-2008 tax incentives
- New location-specific incentive for companies holding high and new-tech status
- New software and integrated circuit ("IC") design incentives
- New IC production industry incentives
- New security investment fund incentives

In connection with the 1 January 2008 implementation of China's new Unified Enterprise Income Tax Law (the "New Law"), the State Council, both directly and through the State Administration of Taxation ("SAT") and Ministry of Finance ("MOF"), has been issuing guidance on issues of immediate importance. This Tax Analysis covers the more important of these issues.

Those interested in China should expect continued guidance and some surprises as the government slowly deals with each open issue and publishes its decisions.

### Dividend Withholding Tax Exemption

Caishui [2008] No. 1 announced at the end of February the much anticipated confirmation that China's new 10% withholding tax on dividends would not be imposed in certain situations. In brief, where a foreign invested enterprise ("FIE") pays a dividend from pre-2008 earnings to any non-resident shareholder, that dividend is exempt from Chinese withholding tax.

This circular does not provide any guidance regarding how the year(s) of the earnings from which the dividend is paid will be determined. Dividends declared during 2008, as a practical matter, will only be out of 2007 and prior years' earnings. As such, for such dividends, this will not be an issue. (While not common in China, it is of course possible that a company could declare in 2008 an interim dividend out of the current year's earnings. Such a dividend would be subject to withholding tax.)

From 2009, designating the years' retained earnings from which a dividend is paid will become a significant issue. In the absence of any "ordering rules" or other guidance that might be issued by the authorities in the future, we suggest that each FIE (or former FIE if that status has been lost) that plans to declare a dividend initiate from 2009 a procedure to identify within the resolution that declares the dividend the years' earnings out of which the dividend will be paid.

From solely a Chinese perspective it will always be best to choose the pre-2008 retained earnings first, which we believe should be acceptable, since that would defer the payment of withholding tax. However, it is possible that an investor's home country foreign tax credit rules might sometimes suggest otherwise. As such, some home country analysis should be conducted before dividends are actually declared.

### Refunds for Reinvestment of Profits

An important feature of the pre-tax reform tax incentives system was the ability of foreign investors to receive refunds of taxes paid by the companies in which they invested by reinvesting the profits either in those companies paying the dividends or in other companies.

Although the New Law has eliminated this tax refund procedure for the future, Guoshuifa [2008] No. 23 issued on 27 February 2008 provides transition rules for claiming refunds related to 2007 reinvestments. (See below under the heading "New IC Production Incentives" for a limited continuing reinvestment refund procedure.)

In brief, foreign investors that have completed their reinvestment transactions and relevant registration procedures with the State Administration for Industry and Commerce (or its local branches) prior to the end of 2007 may apply for their tax refund in accordance with the old tax law. Interestingly, this circular makes clear that no tax refund will be granted for any reinvestment that is made from a 2007 interim dividend.

While there is no stated time limit in the circular for making the tax refund application, we suggest that investors initiate their applications soon.

### Prior Incentives Allowed "Grandfathering" Transition Benefits

Guofa [2007] No.39 ("Circular 39"), issued at the end of December 2007, listed 30 incentives available under the old tax regime that would receive transition benefits. What is interesting is not what was included, but rather what was missing from this list that arguably should have been included, given the broad mandate for transition relief found in the New Law.

These missing items included, for example, certain foreign banks, Sino-foreign joint banks and other financial institutions established in Special Economic Zones or other districts approved by the State Council and FIEs qualifying as high and new-tech companies located in high-tech parks. Caishui [2008] No. 1 eliminates any hope that these types of missing items will receive any transition benefit. As a result, they will pay enterprise income tax ("EIT") from 1 January 2008 at a 25% rate and will not be allowed the transition phase-in rates.

Also not expressly included in the transition benefits listing were certain old law holidays and benefits

granted to software and IC companies. Because of technical legal drafting considerations, it is not perfectly clear that either or both of these had to be “expressly” included in the listing to arguably be covered by Circular 39. As a result, there has been considerable controversy.

Interestingly, as covered in more detail below, Caishui [2008] No. 1 announced very favorable incentives for these two industries. This circular, though, was silent on this controversial issue of whether these two industries would receive transition benefits. This therefore remains an open issue.

Certain preferences allowed by Caishui [2001] No. 202 focused on development of China’s Western Region will continue to be implemented.

It may happen that a company qualifying for transition benefits under Circular 39 also qualifies for some new benefit granted under the New Law and implementation rules. For example, say that a company involved in harvesting forestry products sees that it will be exempt from tax from 2008 under the New Law. It is also listed in Circular 39 as qualifying for transition benefits.

Circular 39 provides that if any transitional benefit overlaps with New Law/implementation rule incentives, a company may choose the more favorable policy, but cannot enjoy both. Further, once a decision is made, the chosen policy cannot be changed. In the example of the forestry company, it would logically choose the new exemption rather than the less beneficial transition relief.

### Final Phase-In Tax Rates and Adjusted Phase-In Tax Rates

After considerable internal governmental discussion, Circular 39 finalized the transition phase-in tax rates for qualifying companies previously paying tax at a 15% rate as follows:

2008	18%
2009	20%
2010	22%
2011	24%
2012 & thereafter	25%

For those that had paid tax at a 24% rate, they move immediately to a 25% tax rate in 2008.

An issue of some controversy was what tax rates would apply to companies qualified for “grandfathering” of both a tax holiday/50% reduction-in-rate incentive (e.g. the “2+3” incentive) and the prior 15% incentive rate. This issue was recently resolved by Caishui [2008] No. 21.

Under this new circular, the tax rate within the half-rate reduction period shall be calculated as 50% of the transition phase-in rates stipulated in Circular 39. This means that the following rates will apply if the indicated year is a half-rate year for a particular company.

2008	9%
2009	10%
2010	11%
2011	12%
2012	12.5%

For companies previously eligible for both the 24% tax rate and a half-rate reduction, the tax rate for each half-rate year is 12.5%, calculated as 50% of 25%.

### Former High and New-Tech Status Companies

The New Law provides that companies qualifying for high-new technology status from 2008 will pay tax at a beneficial 15% rate.

In Guoshuifa [2008] No. 17, the SAT clarified that companies holding this high-new technology status prior to 1 January 2008 must use the normal 25% tax rate in their quarterly tax filing in 2008. They may not use the beneficial 15% until they have received a new 2008 qualification.

Due to the considerably higher 2008 requirements for this status, it is expected that many companies

qualifying in prior years will be unable to continue this status in 2008 and beyond. For many FIEs that only license technology from abroad and that do not either legally or economically own their own technology, qualification will be very unlikely due to the 2008 requirement of ownership of “core intellectual property”.

### 2007 Tax Returns and Settlement Arrangements

Under Guoshuihan [2008] No. 85, the SAT requires that old tax laws and regulations apply for both domestic companies and FIEs regarding their final settlement of EIT and the filing of their 2007 tax returns. However, the tax return filing deadline will be as set under the New Law at five months after the end of the tax year. This represents a one-month later filing deadline.

### Certain Interest and Royalty Withholding Tax Exemptions

Guoshuifa [2008] No. 23 provides transition guidance for certain royalties and interest that had exemptions from withholding tax under the old tax law. In brief, any applicable tax exemption shall continue to apply during the contract period as long as the contract was signed prior to the end of 2007. For any period of extension of the original contract, the exemption will be lost.

### Post-2007 Disqualification on Pre-2008 Tax Incentives

Under Guoshuifa [2008] No. 23, if an FIE enjoying an exemption/reduction (e.g. “2+3” tax holiday incentive) under the old tax law is disqualified for the incentives due to changes occurring in 2008 or later (say, due to changes in its business nature or operational period), the FIE must repay to the government the amount of tax that would have been paid previously had the incentive not been granted. The refund will include any benefits realized during the transition period.

### Location-Specific Incentive for Companies Holding High and New-Tech Status

Although termed a “transition tax incentive”, in Guofa [2007] No. 40, the State Council has unexpectedly continued to a limited extent the prior geographic focus of tax incentives. Applicable only to Pudong and five Special Economic Zones (“SEZs” and including Shenzhen, Zhuhai, Shantou, Xiamen and Hainan), this new incentive applies only to companies newly established from 1 January 2008. Where such companies also hold high and new-tech status, they are granted a “2+3” tax holiday. As a result, they will pay tax at the following rates from their first year of revenue:

Year 1	0.0%
Year 2	0.0%
Year 3	12.5%
Year 4	12.5%
Year 5	12.5%
Year 6	15.0%

To achieve and continue these tax rates, a company will have to re-qualify each year as being high and new-tech status.

### New Software and IC-Design Incentives

Consistent with the innovation/high-tech goals of the government generally and its long-term 15-year innovation-focused plan (2006-2020), Caishui [2008] No. 1 provides a comprehensive approach to strongly encouraging the software production industry in China. Under this circular, this approach is also applied to IC-design companies.

In particular, this circular includes:

- “2+3” incentive for newly established approved software production companies (“SPCs”) beginning from the first profit-making year (i.e., two years of tax holiday followed by three years of 50% reduction-in-rate)

It should be noted that the initiation of this tax holiday (as well as that below for IC production companies) in the first profit-making year is more favorable than the general rule as found for other tax holidays included in the New Law's implementation rules issued in December 2007. There, the holiday period begins in the first year of revenue, even if net taxable losses are being incurred.

- 10% tax rate for key SPCs listed in government plans in any taxable year not otherwise eligible for tax exemption
- Certain value added tax refunds received by SPCs exempt from EIT
- Full deduction for employee training expenses (in contrast to the 2.5% of total employees' salary and remuneration limitation that otherwise would apply)
- Two year depreciable life for approved capitalized purchased software (this benefits the SPCs' customers)
- Western region 80% reinvestment incentive for investment in SPCs (see under "New IC Production Incentives" below)

### New IC Production Incentives

Caishui [2008] No. 1 provides a comprehensive approach to strongly encouraging the IC production industry in China.

In particular, this circular includes:

- "2+3" incentive for approved IC production companies beginning from the first profit-making year when ICs have a width of less than 0.8 $\mu$ m (i.e., two years of tax holiday followed by three years of 50% reduction-in-rate)

This incentive is not applicable for any company that has previously used a "2+3" tax holiday. In contrast to the above described software production and IC-design incentive that requires a newly formed company, this indicates that an existing IC production company that has not previously benefited from a "2+3" tax holiday under old law can qualify under the New Law.

An approved IC production company could potentially qualify as a high and new tech status company, thereby having a 15% tax rate. It is as yet not clear if, in such a case, the three 50% reduction-in-rate years will be taxed at 7.5% or 12.5%.

- "5+5" incentive for IC production companies with a 15-year or more operation period beginning from the first profit-making year when total investment exceeds RMB 8 billion or where produced ICs have a width of less than 0.25 $\mu$ m (i.e., five years of tax holiday followed by five years of 50% reduction-in-rate)

Interestingly, the circular does not include for this "5+5" incentive a similar prohibition against benefiting from two or more series of tax holidays as is mentioned above for the "2+3" incentive. As such, it is perhaps possible that an existing IC production company that qualified for, and benefited from, a tax holiday previously could again benefit from this new "5+5" incentive under the New Law.

Where such a company does not qualify for the special "5+5" holiday (say due to a less than 15 year operation period) or in years not covered by a holiday, a 15% rate will apply. This 15% rate raises the issue of whether a 7.5% rate or a 12.5% rate will apply in the five 50% reduction-in-rate years. At present, there is no guidance on this issue.

- For the three calendar years from 2008 through 2010, refund of 40% of the tax paid by an IC production or assembly company that relates to any profit distributions (i.e. dividends) paid to an investor in that company that reinvests its after-tax share of profits (i) directly back into that company by increasing registered capital or (ii) as capital investment into a newly established IC production or assembly company. A five year operating period is a requirement for both alternatives.

This and the following reinvestment benefits apply to both domestic and foreign investors. The

former receive dividends from other resident companies free of any EIT. The latter, though, are subject to the 10% dividend withholding tax to the extent the profits distributed were earned in 2008 or later years. As covered earlier in this Tax Analysis, any dividends paid out of earlier years' earnings are paid free of this 10% withholding tax. Interestingly, the circular does not include for foreign investors for this reinvestment benefit or for the following one any exemption from this 10% withholding tax. That presumably is still payable.

Note also that if an investor sells all or a portion of its investment or withdraws all or a portion of its reinvested amounts prior to the end of five years for this or the following reinvestment incentive, any tax benefits relating to the sold or withdrawn portion must be repaid to the government. This treatment is based on old law that we do not expect will change.

- For the three calendar years from 2008 through 2010, refund of 80% of the tax paid by any Chinese company that relates to any profit distributions (i.e. dividends) paid to an investor in that company that reinvests its after-tax share of profits as capital investment into a newly established company in China's western region that will operate for five years or more and that is engaged in IC production or assembly or that qualifies as an SPC
- Appropriately reduced depreciation periods as short as three years for approved IC production equipment

### Security Investment Fund Incentives

In addition to the above new "hi-tech" focused incentives, the government has chosen to encourage the continued growth of Chinese security investment funds. As a result, Caishui [2008] No. 1 includes "temporary" exemptions from EIT for security investment funds and their investors.

In China, in addition to pure domestic security investment funds, there are also several special categories. These include:

- Qualified foreign institutional investors ("QFIIs")—Mechanism for foreign investors to invest in the Chinese domestic markets
- Qualified domestic institutional investors ("QDIIIs")—Mechanism for Chinese investors to access foreign securities markets

To date, there have been no clear tax rules for the taxation of foreign investors investing through QFIIs or Chinese investors investing through QDIIIs. Due to the general language of Caishui [2008] No. 1, it is unknown whether its temporary exemptions cover QFIIs, QDIIIs and their investors.

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