CHINA'S NEW ENTERPRISE INCOME TAX LAW: CONTINUITY AND CHANGE

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I INTRODUCTION

From 1 January 2008, enterprises will be taxed by China under the new Enterprise Income Tax Law of the People's Republic of China ('EITL')[1]. As the new law comes into force, the current Foreign Enterprise and Foreign Investment Enterprise Income Tax Law ('FEIT')[2] and Domestic Enterprise Income Tax Regulations ('DEIT')[3] will be repealed. The transition to the EITL marks a long-anticipated and fundamental change to the taxation of the income of enterprises in China. Since their promulgation, the outgoing FEIT and DEIT have together been viewed as transitional measures while China developed its unified EITL.

Despite the imminent and fundamental nature of the change, there is still a lack of detailed information on the new EITL at the time that this article was written. This is because although the law was made public in March 2007, its Detailed Implementing Regulations in relation to the Law have not yet been released.[4]

The content of China's laws is typically limited to general principles, eschewing the level of detail normally seen in the legislative instruments of other countries. As a result, the Detailed Implementing Regulations often contain the more detailed information that is critical to the interpretation of the laws. The rationale for this approach is that it:

- allows laws to develop over time in a dynamic environment;
- is necessary if consensus is to be obtained amongst the relevant law makers and other officials. Consensus would be difficult to obtain with too much detail especially in taxation where there has been significant

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1 Enterprise Income Tax Law of the People's Republic of China, adopted by the Fifth Session of the Tenth National People's Congress of the People's Republic of China on 16 March 2007.

2 Foreign Enterprise and Foreign Investment Enterprise Income Tax Law, adopted by the Fourth Session of the Seventh National People's Congress of the People's Republic of China on 9 April 1991.

3 Provisional Regulations of the People's Republic of China on Enterprise Income Tax, adopted by the Twelfth Routine Meeting of the State Council on 26 November 1993.

4 Possibly they have not yet been drafted in final form.

disagreement on the way forward for China amongst different bodies and individuals;

- allows rapid alteration to the law without going through in-depth debate in the National People's Congress;
- leaves a lot of scope for variation in the operation of the law in different areas and at different times. This allows a substantively different tax regime to be in place when different bodies administer the law despite a façade of national harmonisation.

In fact, for the above reasons, even the Detailed Implementing Regulations are often not detailed when compared to legislation in a jurisdiction such as Australia.

The content of China's new EITL aptly demonstrates the aforementioned generality. A brief reading of the law suggests that fundamental details have been excluded from the law to allow them to be included in later regulations or other pronouncements. See, for example, article 35 of the EITL which states '[d]etailed measures on implementation of the tax incentives provided for in this Law shall be stipulated by the State Council'[5]. Given that there is only the briefest of information given on tax incentives in the preceding ten articles, it is clear that the subsequent stipulations of the State Council will be required for any meaningful analysis of tax incentives that may be available to enterprises under the Law.

It can therefore be seen that, at present, there is a limited amount of original information available on the new EITL. Nonetheless, the Law itself gives an indication of several significant changes to the taxation of enterprises in China – although, the lack of specificity clearly places limitations upon the development of a practical understanding of the operation of the new law. It is on these fundamental changes and their general implications that this article will shortly focus.

Before turning to the most significant changes, it is critical to understand one further issue in relation to the new EITL – namely, the continued relevance of pronouncements and practices that are in place in relation to the current (outgoing) law. It was made clear when the new EITL was announced in March that the new law was not an attempt to completely replace the FEIT and DEIT. Rather, the EITL may be viewed in many respects as the equivalent of Australia's *Income Tax Assessment Act 1997* (Cth) ('ITAA 1997') in the manner in which it attempts to rewrite and clarify the current law. Furthermore, it seeks to incorporate into the law many recent practices that are not contained in the law. A good illustration of this is the express exclusion of sole traders and non-corporate partnerships from the scope of the EITL under article 1. This specific exclusion is not in the FEIT and DEIT, although the exclusion is not new in practice. Such entities were previously excluded through a specific pronouncement. Thus, the EITL is simultaneously all of the following:

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5 EITL, art 35.

- an attempt to rewrite and clarify China's income tax law (similar to the introduction of the ITAA 1997 in Australia);
- an attempt to incorporate current administrative practices into the law; and
- an attempt to introduce several fundamental changes to taxation in China.

The new EITL is therefore not the revolutionary change that it may (at first glance) appear to be. The practical ramification of this is that current practice and pronouncements are still highly relevant in relation to the EITL. Unless a particular interpretation or announcement can be seen to be specifically overwritten by the EITL, it is likely to remain effective. As a result, there remains a high degree of relevance to knowledge of tax practice under the pre-existing law. Unless the EITL specifies otherwise, all the various regulations and announcements promulgated by various bodies in relation to the FEIT and DEIT should be considered when interpreting the EITL.

II STRUCTURAL CHANGES RESULTING FROM THE EITL

With the above analysis in mind, it is possible to examine the major structural changes that will occur with the introduction of the EITL. These include (in brief):

- a reduced tax rate of 25 per cent;
- a more restrictive tax incentive regime (or more generous from the perspective of domestic enterprises);
- taxation of both foreign and domestic enterprises under the same law;
- altered jurisdictional nexus rules that go beyond place of registration or formation;
- introduction of controlled foreign company provisions and attribution;
- altered limits on certain deductions including donations and wages (in relation to domestic enterprises); and
- introduction of thin-capitalisation rules, a refinement of transfer pricing rules and the introduction of a general anti-avoidance provision.

A Tax Rates under the EITL

One critical outcome of the implementation of the EITL is a change in the tax rate. This change is not a difficult change to understand. Nonetheless, it was one of the biggest points of interest (and contention) in the development of the EITL. The rate of 25 per cent is a material reduction from the rate of 33 per cent that applies under both the FEIT and DEIT. For this reason there was some concern about lost revenue when the new law comes into effect. However, there are significant tax incentives available under the current FEIT. The reduced tax rate has to be understood in the context of the intention on the part of China's government to significantly curtail the range of tax incentives available to businesses and foreign investors alike. In the case of foreign investors, the EITL will in many cases represent an increase in the applicable tax rate. On the other hand, domestic enterprises will largely benefit from the reduced tax rate, thus increasing the parity between both the domestic and foreign sectors.

The reason this change was contentious is that large parts of China's government worried that an increase in tax rates for foreign investors would lead to a reduction in foreign investment levels. The outcome of 25 per cent is hoped to be a low enough rate to achieve the possibly conflicting goals of:

- attracting foreign investment through a competitive tax environment;
- neutrality between foreign and domestic taxpayers;
- collecting sufficient income tax for government purposes; and
- providing a simpler tax law that swaps a generally lower rate for a myriad of incentives.

Two final points to note in relation to tax rates under the EITL are that, first, like the DEIT, it provides a lower rate (20 per cent) for small scale enterprises. Second, the withholding-style taxation of the China source income of non-resident enterprises without establishments in China remains under the EITL as does the rate of 20 per cent. It remains to be seen whether the reduction of this withholding rate to 10 per cent in practice will continue in 2008.

B Tax Incentives under the EITL

As mentioned above, one of the key policies underpinning the introduction of the EITL was a reduction of tax incentives offered to foreign investors along with a reduction in the corporate tax rate. At the same time, the EITL ensures that those incentives that remain are also available to domestic enterprises. It is therefore no surprise that the law offers far fewer incentives. The incentives that do remain, however, are focused primarily upon infrastructure, the environment, primary production and technology transfer. The descriptions of the incentives under the EITL are far vaguer than under the FEIT and few specific incentives are expounded upon in any great detail. There is therefore greater scope for governmental control on the availability of incentives. The only incentive in the form of a reduced tax rate that is clearly available under the EITL is the 15 per cent rate offered to Advanced and New Technology Enterprises under article 28.

The tax incentive situation is a major change in relation to foreign investors. This is particularly notable in cases such as the Special Economic Zones ('SEZs') where, under the outgoing law, virtually all foreign investment enterprises were receiving a low tax rate. The same was the case under the outgoing law for FIEs that were productive enterprises regardless of location and specific nature of productive activity. Given that it is possible to be based within a SEZ and access opportunities elsewhere, it could be said that FIEs virtually never paid the full 33 per cent under the FEIT. It can be seen that this situation has now ended with the government regaining significant control in relation to the granting of incentives while also reducing the scope of the grants. Of course, the vague nature of the availability of incentives will lead to uncertainty and the possibility for inequitable grants if future regulations do not provide greater clarification on the criteria involved in the decision-making process.

C Jurisdictional Nexus Rules under the EITL

Between the DEIT and FEIT, China taxed enterprises formed within China on their worldwide income, whilst those formed outside China were taxed on their China source income. This was regardless of the nationality of the underlying controllers or of the place of central management and control of the enterprise. This situation was open to significant criticism as the rules were easily circumvented particularly by Chinese entities seeking to avoid taxation on their foreign source income. All that was necessary for a Chinese enterprise to avoid the taxation of foreign source income was to ensure that the company formation occurred in a foreign jurisdiction. Thereafter, all management decisions could be made in China and all control exercised by Chinese parties. Whilst this was legal under the DEIT and FEIT, it was clearly against the spirit of the law which sought to tax Chinese enterprises on their worldwide income. The EITL sets out to rectify this problem by including as resident entities not only those formed in China but also those whose place of effective management is in China.

The inclusion of enterprises that have their place of effective management in China in the definition of resident will have a direct impact on domestic interests endeavouring to avoid taxation on their foreign source income. However, it will also have an impact on foreign registered enterprises controlled by foreign interests that have a significant presence in China such that it may be argued that they have their place of effective management in China. Although there is not currently any detailed information on what will constitute the place of effective management, it is clear that this new category of entities taxable on their worldwide income constitutes a major change to tax practice in China.

A final adjustment to the jurisdictional nexus rules under the EITL is the express inclusion in the tax base of foreign source income of a foreign enterprise (without its place of effective management in China) when it is connected to an establishment in China. This taxing outcome may previously have been achieved only through the operation of certain double tax agreements that deem profits attributable to a permanent establishment to be sourced in the country for domestic tax purposes.

D Controlled Foreign Companies

In keeping with the policy of strengthening its tax jurisdictional claim, China has introduced controlled foreign company ('CFC') rules in the EITL. This is unsurprising given the efforts to strengthen the definition of 'resident' reviewed in the previous section. Without complimentary CFC rules, the residence provisions could still be circumvented by domestic concerns by ensuring that the foreign enterprise has its place of effective management outside of China. Whilst this is not as easy as simply incorporating outside of China, it is still readily achievable for many concerns.

China's inclusion of CFC rules in the EITL means that its income tax regime is now taking on features in common with the more advanced tax regimes found in developed countries and this comes hand in hand with increased complexity and the likely introduction of many new issues for tax administrators and taxpayers alike. At present very little information is given in the EITL as to how the CFC rules will function. A review of article 45 provides the following essential requirements for attribution that will likely be elaborated upon in the future:

- a resident enterprise alone or together with other residents must control a foreign enterprise;
- the tax rate applicable in the foreign country must be distinctly lower than the Chinese tax rate;
- the foreign enterprise must not have distributed its profits; and
- the foreign enterprise must not have reasonable operational needs for not distributing profits.

When all the above conditions exist the income of the foreign enterprise will be attributed to the Chinese enterprise controller. The above basic conditions clearly leave much room for further detail, particularly in relation to the following issues:

- A key issue with CFC legislation in other jurisdictions is the definition of control. It would therefore be expected that much more detail will arise to clarify if control will be subjective, quantitative or both. In addition, the taxpayer relationships that might be included in determining control will need to be elaborated.
- The statement that the tax rate in the foreign jurisdiction must be 'distinctly lower' before attribution can occur is exceedingly vague and needs clarification. Other issues are also likely to arise due to the law's focus on country of establishment which may not be the same as where the enterprise is seen as being resident.
- The focus on 'reasonable operational needs' for not distributing profit is an interesting approach which distinguishes the Chinese approach to CFCs from that of Australia. Again, this is an issue that needs clarification and also one that is likely to lead to significant compliance issues and debate in the future as precedent is sought as to what is a reasonable operational need. It is possible that some form of mechanical test will be developed.

Thus it can be seen that article 45 is a very significant addition to China's income tax law and one that will inevitably become a major issue in future years. A final point worthy of mention is the lack of CFC rules under the Individual

Income Tax.[6] It would seem that the government might be forced to consider their introduction in the future or else tolerate the large arbitrage opportunity that will arise due the differences that exist under the two income tax laws in relation to CFCs.

E Other International Tax Rules and General Anti-Avoidance Provisions

In its sixth chapter, the EITL introduces not only the CFC rules discussed above but also an anti-thin-capitalisation provision, transfer pricing rules and what may be regarded as a general anti-avoidance rule. The thin-capitalisation rule is new to Chinese income tax and is specified in article 46 of the law. On reading this article, it is again evident that more detail is needed. The article essentially denies interest deductions when related party debt is excessive. What constitutes excessive debt is not specified at this stage, however, and will hopefully be included in the detailed regulations. Structurally, China's new thin-capitalisation regime has more in common with provisions such as those found in Australia prior to 2001. That is, it is firmly focused on related party debt and not overall excessive debt funding. This approach was abandoned in Australia due to the sentiment that it inadequately dealt with the debt allocation of multi-national enterprises where related parties were not the key issue but rather overall debt allocation policies. China's new rule is therefore a step forward but possibly not a large enough one given China's overall engagement with international markets and the significant presence of multinationals in China.

Articles 41-44 of the new law refine China's transfer pricing rules. It may however be argued that this does not represent a significant departure from the current position where transfer pricing is already well defined. What is new is the specific requirement in the law that an annual report on related party transactions be submitted by taxpayers. Finally, article 47 of the EITL introduces a specific anti-avoidance rule into the Chinese income tax. This rule allows the tax administrator to disregard or adjust business arrangements when they can be said to be without reasonable business purposes. While general anti-avoidance rules such as this have had a very significant impact in jurisdictions such as Australia, it is questionable whether this impact will be as great in China. This is because China's tax system (in its current state) leaves a lot of scope for interpretation and discretion in the hands of the administrator and reduced scope for pro-taxpayer findings by courts in the event of a dispute. Given this, there is a reduced need for a general anti-avoidance rule.

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6 Law of the People's Republic of China on Individual Income Tax, adopted by the Third Session of the Fifth National People's Congress on 10 September 1980; amended for the first time in accordance with the Decision of the Fourth Session of the Standing Committee of the Eighth National People's Congress Concerning Amendment to the Law of the People's Republic of China on Individual Income Tax on 31 October 1993; amended for the second time in accordance with the Decision of the Eleventh Session of the Standing Committee of the Ninth National People's Congress Concerning Amendment to the Law of the People's Republic of China on Individual Income Tax on 30 August 1999; amended for the third time in accordance with the Decision of the Eighteenth Session of the Standing Committee of the Tenth National People's Congress on Amending the Law of the People's Republic of China on Individual Income Tax on 27 October 2005.

F Transitional Provisions

A final point of interest with the new EITL is the transitional provisions in relation to tax incentives granted under the outgoing tax laws. Review of article 57 of the EITL reveals that enterprises that received approval for establishment prior to the promulgation of the new law will be allowed to enjoy tax incentives granted under the old laws for a transitional period of five years. During this time their tax rates will gradually be increased to accord with the new law. Additionally, enterprises that have been granted a tax holiday will retain that benefit whilst those that have not been able to take advantage of it due to losses will be able to enjoy it when they become profitable.

Article 57 does not completely shut the door to tax incentives. Rather, this article again gives ample scope for the grating of tax incentives in both the transitional period and beyond. As discussed earlier these will clearly be at the discretion of the relevant authority rather than being an entitlement clearly guaranteed in the law itself.

III CONCLUDING COMMENTS

This article has attempted to convey two key messages in relation to China's new EITL:

- that fundamental change is afoot in China's taxation of enterprises; and
- there is significant continuity with the recent past despite the changes.

The second message cannot be overstated given that it is often ignored in commentary on the new EITL. It is clear that the new law has not attempted to change all aspects of taxation in China. In fact, a thorough reading of the law demonstrates the possibility for things to remain reasonably similar. Thus, many changes are couched in vague terms with allowances for current practice to continue at the discretion of the relevant authorities. In addition, some of the unique aspects of China's income tax practice remain. Key amongst these is the continuation of the enterprise tax unit with the interesting practical outcomes this creates. Arguably the issues raised by the enterprise tax unit are more critical than ever given the expansion of China's jurisdictional claim through the stronger residence test and the introduction of CFC rules.

The other key feature of China's tax laws that set them apart from that of many developed countries is their brief, general nature that leaves many issues open to interpretation and administrative discretion. This has remained a feature of the EITL and has arguably been exacerbated. One can therefore conclude that tax practice in all its guises will remain a rather unique experience and a challenge for the foreseeable future. The Detailed Implementing Regulations are highly anticipated and may soon be available. Given just how much information is needed to understand the EITL, however, it is doubtful that even these regulations will provide all the answers. It is probable that the EITL will develop over time, possibly at different rates and in a different directions depending upon the location within China. The continued split in administration of the EITL between the Local Office, the National Tax Office and all their component parts will ensure this remains the case.