



Grandfathering Treatments Available to Old Foreign Investment Enterprises and High/New Tech Enterprises Newly Established in Specific Regions

The State Council released two important tax circulars dated 26 December 2007 but only publicised on 29 December 2007, just before the end of 2007, addressing the grandfathering treatments available to old foreign investment enterprises ("Old FIEs") (referring to FIEs whose business registration have been completed on or before 16 March 2007) and high/new tech enterprises ("HNTEs") newly established in certain specific regions under Article 57 of the Corporate Income Tax Law ("CIT Law").

Guofa [2007] No.39 ("Circular 39")

The first circular is Circular 39 which mainly addresses the grandfathering treatments available to Old FIEs. It provides the detailed rules on the phasing-in of the CIT rate of Old FIEs which are currently enjoying an income tax rate of lower than 25% under the Foreign Enterprise Income Tax ("FEIT") regime to the statutory rate of 25% within the five-year period as stipulated in Article 57 of the CIT Law. The following table summarizes the transitional arrangement:

FEIT regime	CIT regime	Phasing-in of CIT rate
24%	25%	Change will take place on 1 Jan 2008
15%	25%	The rates will gradually increase in the following manner: 2008 18% 2009 20% 2010 22% 2011 24% 2012 25%

For those FIEs which were subject to 33% FEIT tax, the new applicable CIT rate will be 25% starting from 1 January 2008.

It also addresses the grandfathering treatments of unutilized tax holiday of Old FIEs. For those Old FIEs which have already commenced their tax holidays before 2008, they can continue to enjoy the remaining unutilized tax holidays until expiry. For those Old FIEs which have not commenced their tax holidays before 2008 due to losses, their tax holidays will be deemed to commence in 2008 and can be utilized until expiry.

For sake of clarity, Circular 39 has an appendix showing the types of tax incentives under the FEIT regime which qualify for the grandfathering treatments.

Circular 39 also states that the existing preferential tax policy available to enterprises established in the Western Region as stipulated in Caishui [2001] No.202 will continue to apply. This means those enterprises currently enjoying an income tax rate of 15% under that policy can continue to enjoy the same until its expiry in 2010 and those enterprises currently eligible for a "2+3" tax holiday under that circular can continue to enjoy the tax holiday until expiry.

It also clarifies that for an enterprise which qualifies for the grandfathering treatments and also new tax incentives under the CIT Law which cross over the above treatments, it is allowed to choose the one which is more preferential. This implies that there should be no duplication of benefits to be enjoyed. In addition, once the choice is made, it cannot be changed. Based on the literal reading of Circular 39, an example of this could be an FIE engaging in primary industries, e.g., the raising of livestock. Such FIE should qualify as "Production Enterprise" under the FEIT regime and be eligible for the grandfathering treatment if it has unutilized tax holiday. At the same time, income from such project is exempt from CIT under the new Law. In that respect, the FIE can choose between the grandfathering treatment of using such unutilized tax holiday and the exemption available under the CIT Law, and obviously the FIE would choose the latter one.

Guofa [2007] No.40 ("Circular 40")

The second circular is Circular 40 which addresses the tax incentive available to HNTes newly established within certain specified regions as stipulated in Article 57 of the CIT Law. Circular 40 clarifies that the specific regions refer to the five special economic zones (namely, Shenzhen, Zhuhai, Shantou, Xiamen and Hainan) and the New Area of Pudong ("5+1 Zones") and the tax incentive applies to HTNEs established in the 5+1 Zones on or after 1 January 2008.

The tax incentive is in the form of a tax holiday of two-year exemption and three-year 50% tax rate reduction, with the holiday commencing from the first-income generating year (instead of "first-profit making year" which was generally applied under the FEIT regime). In addition, the 50% tax rate reduction is based on the statutory rate of 25% rather than the preferential income tax rate of 15% available to HTNEs under the CIT Law. This implies that the income tax rate for these new HTNEs will be as follows: 0% for the first two years, 12.5% for the next three years, and 15% thereafter.

The qualifying criteria for these new HTNEs are the same as those provided for under Article 93 of the CIT Detailed Implementation Regulations ("DIR"), namely core proprietary IP right and other prescribed criteria. To avoid the old problem of "registration within the zone but operating outside the zone", the tax holiday is only applicable to profits derived within the 5+1 Zones. Any profits derived outside the 5+1 Zones will not be eligible for the tax holiday. If the new HTNE has operations both within and outside the 5+1 Zones, it has to segregate its income and expenses between the two operations on a reasonable basis; if it fails to do so, then it will not be allowed to enjoy the tax holiday at all.

Further, if such HTNE is re-assessed on its qualifying criteria during the tax holiday period and fails the re-assessment, it will not be allowed to enjoy the tax holiday commencing from the year in which it fails the re-assessment. Even if it subsequently qualifies again as an HTNE, it cannot resume the remaining tax holiday or re-run a new round of the tax holiday.

PwC Observation

The two circulars have provided clarity on the criteria, scope and tax incentives addressed under Article 57 of the CIT Law. Most of them confirm our previous understanding. This will be helpful to most FIEs in assessing the tax profiles under the new CIT regime. For instance, the announcement of the detailed rules on the phasing-in of the CIT rate for Old FIEs which are currently enjoying an income tax rate of lower than 25% under the FEIT regime to the statutory rate of 25% over the five year period will now provide statutory support to these FIEs for booking their deferred taxes. However, there are still some issues relating to grandfathering treatments which are still unclear. To name a few here:

- the phasing-in of the income tax rate for non-productive Old FIEs established in the New Area of Pudong under the FEIT regime. The preferential income tax rate of 15% for non-production enterprise established in the New Area of Pudong does not appear in the appendix to Circular 39 of the types of tax incentives under the FEIT regime which qualify for the grandfathering treatment. In that respect, it is doubtful whether such non-productive FIEs will qualify for the phasing-in of the income tax rate from 15% to 25% as stated in the above table or immediately subject to 25% starting from 2008.

- The preferential income tax rate of 15% for Old Enterprises which have qualified as HNTEs ("Old HNTEs") under the FEIT regime is not in the list of tax incentives provided in the appendix to Circular 39, while the tax holiday for such Old HNTEs is. This would indicate that there is no grandfathering treatment on the 15% preferential income tax rate. An Old HNTE may enjoy the 15% income tax rate for HNTE under the CIT regime only if it satisfies the new HNTE criteria. Otherwise, it should be subject to the standard CIT rate of 25% from 2008. As to the grandfathering of tax holiday, an Old HNTE which also qualifies as an HNTE under the CIT regime would appear to be eligible for the unutilized tax holiday, if any. However, it is unclear whether those Old HNTEs which could not qualify as HNTEs under the CIT regime would be eligible for the grandfathering treatment. A literal reading of the appendix to Circular 39 seems suggesting that it would, but this is contrary to our understanding from previous discussion with some Chinese tax officials.
- Both circulars do not mention the grandfathering treatments in respect of other tax incentives provided under the FEIT regime, e.g. the 3-year extended tax holiday for the Technologically Advanced Enterprises, Reinvestment Refund out of the pre-2008 profits, Export-oriented Enterprises, tax credit for purchase of domestically made equipment, etc. On one hand, these types of tax incentives will not survive under the new CIT regime. On the other hand, it appears that these original tax incentives would not be grandfathered, unless the Chinese authorities provide further concessions under separate circulars later on.

These two State Council circulars are just two of the many circulars and guidelines which are expected to be issued by the Chinese authorities in the near future to further clarify the CIT Law and its DIR. We will share with you timely any important updates on these circulars and guidelines in future issues of PwC News Flash.

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