



## New Corporate Income Tax Circulars on Grandfathering Treatments for Tax Incentives

In our 2008 Issue 1 of our China Tax / Business News Flash, we reported two important tax circulars, Guofa [2007] No.39 ("Circular 39") and No.40 ("Circular 40"), issued by the State Council in late December 2007 addressing the grandfathering treatments of tax incentives available to old foreign investment enterprises ("Old FIEs") and high/new tech enterprises newly established in certain specific regions respectively. Then, three new important tax circulars with wide spread impact to FIEs and their foreign investors were issued in February 2008, namely:

- Caishui [2008] No.1 and No.21 jointly issued by the Ministry of Finance ("MoF") and the State Administration of Taxation ("SAT"); and
- Guoshuifa [2008] No.23, issued by the SAT.

These tax circulars clarify the implementation details in relation to certain unclear grandfathering treatments of tax incentives under Circular 39. In addition, it is imperative to note that some tax incentives available to certain industries under the FEIT regime are brought over to the Corporate Income Tax ("CIT") regime which have not been mentioned under the CIT Law and its Detailed Implementation Rules ("DIR"). We discuss below the salient points of each of these three circulars.

### Caishui [2008] No.21 ("Circular 21") dated 4 February 2008

Among others, Circular 21 mainly clarifies how the half-rate reduction during the unutilized tax holiday period should overlay with the gradually increased tax rates during the grandfathering period addressed in Circular 39.

Some Old FIEs are eligible for grandfathering treatments of the preferential tax rate of 15% and unutilized tax holidays under the FEIT regime as allowed by Circular 39. Circular 21 clarifies that the half-rate reduction during the unutilized tax holiday period should be calculated based on the gradually increased tax rates of 18%, 20%, 22%, 24% for year 2008, 2009, 2010 and 2011 respectively and then 25% for year 2012 and beyond. Effectively, the net rates will be 9%, 10%, 11%, 12% and 12.5% depending on the year in which the half-rate reduction will apply. Where the Old FIEs were subject to 24% or 33% under the FEIT regime, then the half-rate reduction during the unutilized tax holiday period, if any, should be calculated based on 25%. Effectively, the net rate will be 12.5%. This is consistent with our previous understanding.

### Caishui [2008] No.1 ("Circular 1") dated 22 February 2008

Based on the approval of the State Council, the MoF and SAT announced Circular 1 which mainly addresses new tax incentives available to certain industries on the basis of Article 36 of the CIT Law:

#### 1. Special tax concession for Withholding Tax on Dividends

The DIR states that dividend shall be recognized as income on the day in which the investee makes a resolution to make profit distribution (normally on the annual board meeting date). Hence, in theory, where an FIE distributes its retained earnings for year up to year 2007 in year 2008 (or beyond), the dividend is recognized as taxable income of its foreign investor in year 2008. Consequently, its foreign investor would be subject to Withholding Tax at 10% on the dividend according to the DIR.

This has been a controversial issue because foreign investors were specifically exempted from Withholding Tax in respect of their dividends income under the FEIT regime. In most cases, such Withholding Tax would be affecting the return on investment from the FIE.

Many parties, including sizable MNCs, industry associations, and tax professionals, etc., have requested the Chinese tax authorities to grant a special concession to waive the Withholding Tax on dividends arising from the FIEs' pre-2008 retained earnings in order to facilitate a smooth transition from the FEIT regime to the CIT regime. Now, it is very encouraging to see that the Chinese authorities have accepted the request. Circular 1 states that the pre-2008 retained earnings of an FIE shall be exempt from Withholding Tax when they are distributed to its foreign investor in 2008 and beyond. However, the FIEs' profits arising in year 2008 and beyond to be distributed to the foreign investor as dividends shall be subject to Withholding Tax according to the CIT Law and DIR.

We are given to understand that the Chinese authorities are considering whether to adopt an application and examination procedure in 2008 to verify the amounts of FIEs' undistributed retained earnings up to the end of 2007 which are eligible for this special concession of Withholding Tax exemption.

## **2. Tax incentives for software, integrated circuit ("IC"), and security investment funds industries**

Circular 1 provides generous tax incentives to software production companies, IC production companies, as well as security investment funds. Please refer to the Appendix to this News Flash for the details. These tax incentives are basically the same as those granted under the previous regime (reference: Caishui [2000] No.25, Caishui [2002] No.70, Caishuizi [1998] No. 55, and Caishui [2002] No.128, etc.).

It is interesting to note that while the reinvestment tax refund policy has been cancelled under the CIT regime, such preferential treatment will continue to apply to reinvestment in relation to IC production and assembly companies in general and software products production companies newly set up in the Western Region. On the other hand, the starting time for tax holidays under the CIT regime is generally the "first revenue-generating year". Rather, the starting time for tax holidays for software production companies and IC production companies mentioned in Circular 1 remains the same as that under the FEIT regime, i.e. the "first profit-making year".

In some cases, the incentives offered to these three industries under Circular 1 are even more favorable than comparable incentives granted to other industries under the CIT regime. This demonstrates the State's determination to encourage and support these industries' developments.

## **3. Transitional arrangements of preferential tax policies available to certain industries and enterprises under the previous regimes**

Circular 1 allows the continuation of 6 types of fixed-period preferential tax policies available to certain critical industries and enterprises until their expiry, namely re-employment, 2008 Olympic Games and 2010 World Expo, social welfare, enterprise reform, agriculture and state reserves, etc.

Most of these preferential policies are for domestic enterprises or organizations. This also clarifies some unclear issues. For instance, sponsorship expenses incurred by the official sponsors for 2008 Olympic Games were allowed to be deductible for income tax purposes, while the CIT regime renders the same non-deductible in general. Circular 1 now makes good the deduction to restore the original tax treatment.

## **Guoshuifa [2008] No.23 ("Circular 23") dated 27 February 2008**

Circular 23 further clarifies the implementation details in relation to certain unclear grandfathering treatments of previous tax incentives under Circular 39:

1. Reinvestment tax refund -- The cut-off point in respect of reinvestment tax refund should be the completion of the necessary registration with the State Administration for Industry and Commerce (or its equivalents at local level). In other words, in order to qualify for reinvestment tax refund, the foreign investor and the FIE have to complete all reinvestment steps and obtain the updated Business License

(in case of capital increase to the FIE itself) or the new Business License (in case of reinvestment to set up a new company) on or before the end of 2007. In addition, reinvestment tax refund is not allowed in the case where the reinvestment funding was taken out of the pre-payment of 2007 profits (interim dividends), which indicates that the 2007 profits are not eligible for reinvestment tax refund in any case.

It has generally been recognised that no further extension or lenient grandfathering treatment of reinvestment tax refund would be allowed as this policy has not been so supportive by the Chinese authorities even under the FEIT era. However, the expelling of 2007 profits from reinvestment tax refund policy is a relatively harsh position. Nevertheless, it is understandable to see such harsh position for technical reasons, namely the 2007 profits cannot be finalised as distributable until the beginning of 2008, and the reinvestment actions for such distributable profits by a foreign investor could only take place in 2008 and beyond under the CIT regime which does not have the reinvestment tax refund policy.

2. Withholding tax on interest, royalty, etc. to foreign enterprises in relation to pre-2008 contracts -- For contracts involving interest, royalty, etc. entered into before 2008 which met the Withholding Tax exemption criteria under the FEIT Law and already approved by the tax authorities, the Withholding Tax exemption will continue to apply until the expiry of the original contracts. However, this transitional treatment shall not apply to any extension, supplementary contracts, or expansion of scope of the original contracts.

This grandfathering policy is reasonable and welcomed by many foreign enterprises deriving such passive income from China. However, they should check to see whether there were any extension, supplements or other kinds of amendments made after the original contracts were approved by the tax authorities, as this might jeopardise the WHT exemption otherwise allowed under this grandfathering policy. Circular 23 requires their in-charge tax authorities to follow up on the actual situation to ensure that there is no abuse.

3. FIEs eligible for grandfathering treatments of various kinds of unutilized tax holidays should still observe the original requirements stipulated under the FEIT regime for such tax holidays in 2008 or beyond, namely their business nature (scope) and operation period. For example, one of the requirements for "Production FIEs" to enjoy the 2+3 tax holiday is that it has to operate for a period of not less than 10 years; and if such FIE ceases operation after 2007 and fails to fulfill the 10 year operation-period requirement, then there would be claw-back of the tax exempted / reduced during the tax holiday, including the part falling under the grandfathering period post-2007.

This requirement is reasonable as it is not more than what was required under the original FEIT regime. This policy seems to restrict the tax planning of injecting new lines of business into an "Old FIE" taking advantage of its grandfathering treatment in respect of the unutilized tax holiday, if it causes a change to that Old FIE's original business nature (scope). However, it does not explicitly address whether the expansion of the business scale by way of new investment into the same "Old FIE" in 2008 and beyond (or even after 16 March 2007) would cause any risk of claw-back.

## **PwC Observation**

In light of these three circulars, we have the following observations:

### **1. Cancellation of other tax incentives under the previous income tax regimes**

Circular 1 reinforces that all tax incentives under the previous income tax regimes, other than those provided in the CIT Law and its DIR, Circular 39, Circular 40 and this Circular 1, will be cancelled as of 1 January 2008. It also prohibits local authorities granting preferential CIT policies outside their authority.

Actually, the CIT and DIR have clearly stated that the FEIT regime (and Enterprise Income Tax ("EIT") regime for domestic enterprises) has been annulled as of 1 January 2008. Consequently, all the previous tax incentives which were based on the FEIT Law and its then DIR are void in general. In case the Chinese authorities decide to keep some of the previous tax incentives, they will come up with new rules and regulations under the relevant provisions of the CIT Law or DIR.

Therefore, in determining whether the previous tax incentives would survive under the CIT regime or not, companies should not take it for granted that as far as there is no circular specifically annulling the previous tax incentive, then it should remain valid. For instance, none of the CIT Law and its DIR, Circular 39, Circular 40 and Circular 1 mentions about the grandfathering of unutilized tax holidays for "Technologically Advanced Enterprise" beyond 2007, then any company gaining such designation in 2007 or before should assume that the unutilized tax holiday is not allowed for 2008 and beyond.

## **2. Development of tax incentives under the new regime**

Conversely, Circular 1 brings some previous tax incentives over to the new regime, such as the generous tax incentives to software production companies, IC production companies, as well as security investment funds, and grants special concession of Withholding Tax exemption for dividends out of pre-2008 retained earnings, etc. They are not explicitly mentioned under the CIT Law or DIR.

It indicates the possibility that in future, the State may keep some previous tax incentives valid or formulate new tax incentives not mentioned in the CIT Law and DIR, as long as these tax incentives are supportive to the State's sustainable developments. Therefore, companies which do not find any tax incentives relevant to their businesses or situations under the CIT Law and DIR should stay on top of any development of tax incentives.

We will closely monitor this development and share with you timely any important updates in future issues of PwC News Flash.

## APPENDIX

### Tax incentives for software, integrated circuit ("IC"), and security investment funds industries

#### 1) For software production companies

- a. VAT rebate used for R&D and production expansion will be exempt from CIT.
- b. Newly established software production companies will qualify for a tax holiday of "two-year exemption and three-year half-rate reduction" ("2+3 tax holiday") starting from the first profit-making year.
- c. Key software production companies listed in the State's plan will be eligible for a reduced CIT rate at 10% if no other tax exemption is applicable for a given year.
- d. Staff training expenses incurred by software production companies are deductible.
- e. Software purchased by enterprises is allowed to be depreciated or amortized over a minimum period of two years upon approval by tax authorities.
- f. IC design companies are treated as software production companies for the purpose of enjoying the above tax incentives.

#### 2) For IC production companies

- a. Depreciation period for production equipment of IC production companies is allowed to be shortened to a minimum of 3 years upon approval by tax authorities.
- b. IC production companies with total investment exceeding RMB8 billion or which produce ICs with a width of less than 0.25um may be eligible for a reduced CIT rate of 15%; and, if the operation period of the company is more than 15 years, it may also be eligible for a tax holiday of "five-year exemption and five-year 50% half-rate reduction" starting from the first profit-making year.
- c. IC production companies which produce ICs with a width of less than 0.8um may be eligible for a 2+3 tax holiday starting from the first profit making year after confirmation. However, this incentive would not apply to companies that have already enjoyed the general 2+3 tax holiday.
- d. For the period from 2008 to 2010, where the investor of an IC production or assembly company reinvests its after-tax profits obtained from the IC production or assembly company to increase the capital of that company or establish a new IC production or assembly company which operates for a period of not less than 5 years, it will be eligible for a reinvestment tax refund of 40% of the income tax already paid on the reinvested amount. The reinvestment tax refund would be clawed back if the reinvestment is withdrawn within 5 years.
- e. For the period from 2008 to 2010, where any investor (both domestic and foreign) reinvests its after-tax profits obtained from within China to establish a new IC production or assembly company or software products production company in the Western Region which operates for a period of not less than five years, it will be eligible for a reinvestment tax refund of 80% of the income tax already paid on the reinvested amount. The reinvestment tax refund would be clawed back if the reinvestment is withdrawn within 5 years.

#### 3) Tax incentives for securities investment funds

- a. Income derived by securities investment funds from the securities market (including gain from sales of stocks and bonds, dividend or bonus from stocks, interest of bonds, etc) is temporarily exempt from CIT.
- b. Income derived by investors from distribution from securities investment funds is temporarily exempt from CIT.
- c. Gain derived by fund managers from trading of stocks and bonds using the securities investment funds is temporarily exempt from CIT.

In the context of this China Tax / Business News Flash, China or the PRC refers to the People's Republic of China but excludes Hong Kong Special Administrative Region, Macao Special Administrative Region and Taiwan Region.

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