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Tax Incentive Policies for Foreign-Invested Enterprises in China and their Influence on Foreign Investment

Abstract

Since opening its markets in the late 1970s, China has applied separate income tax regimes to foreign invested enterprises (FIEs) to the disadvantage of domestic enterprises. As a result, China has attracted massive foreign investments and imported advanced technologies, but has ingrained defects into its economy and investment environment. This article reviews the development of China's tax incentive policies, and analyses their effect on FIEs. It also explains the changes to tax incentive policies after the enactment of the new Enterprises Income Tax Law. This law indicates the growth of China's economic regime and the shift towards a more mature and systematic taxation regime that will effectively utilise foreign direct investment (FDI). The new taxation regime will facilitate the structural change necessary for economic growth, and reinvigorate the suffering industrial structure of the nation and its many regions.

Keywords

Tax incentives, foreign investment enterprises, foreign invested enterprises, investment in China

TAX INCENTIVE POLICIES FOR FOREIGN-INVESTED ENTERPRISES IN CHINA AND THEIR INFLUENCE ON FOREIGN INVESTMENT

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Since opening its markets in the late 1970s, China has applied separate income tax regimes to foreign invested enterprises (FIEs) to the disadvantage of domestic enterprises. As a result, China has attracted massive foreign investments and imported advanced technologies, but has ingrained defects into its economy and investment environment. This article reviews the development of China's tax incentive policies, and analyses their effect on FIEs. It also explains the changes to tax incentive policies after the enactment of the new *Enterprises Income Tax Law*. This law indicates the growth of China's economic regime and the shift towards a more mature and systematic taxation regime that will effectively utilise foreign direct investment (FDI). The new taxation regime will facilitate the structural change necessary for economic growth, and reinvigorate the suffering industrial structure of the nation and its many regions.

INTRODUCTION

From their commencement in the 1980s, foreign-invested enterprises (FIEs) have flourished because of a policy of enlightened tax incentives in the past two decades in China. This article focuses on the development of tax incentive policies for FIEs in different stages of economic growth and their impact on FIEs. It also details the new tax preferences and future influences.

For the past 26 years, China has operated a dual tax system, with different tax laws and incentive rules, for Chinese enterprises and for FIEs, which has resulted in very significant disparities in the effective tax rates generally applicable to domestic Chinese enterprises and to FIEs. FIEs have enjoyed more favourable tax treatment than their domestic counterparts, enjoying preferential tax rates, tax deductions and tax holidays.

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The enactment of the *Enterprise Income Tax Law* (herein Law 2007) on 26 March 2007, FIEs are brought under the same tax regime as local enterprises. Law 2007 unifies the income tax treatment of domestic and foreign enterprises by consolidating the *Provisional Regulations on Enterprise Income Tax*, applicable to domestic Chinese enterprises, and the *Law of the People's Republic of China on the Income Tax for Foreign-invested Enterprises and Foreign Enterprises*, applicable to FIEs and foreign enterprises. Later, the *Implementation Rules of Enterprise Income Tax Law* (hereafter referred to as Rules 2007) was officially issued after a long gestation period. These regulations, taking effect 1 January 2008 represent a milestone in China's taxation history, and indicate a fundamental change in China's tax incentive policy.

This article begins with discussion of the first stage of Chinese legislation granting tax preferences in the early 1980s, and analyses the introduction of tax preferences and the first stage of legislation and its impact on attracting foreign investment. Second, the article will describe the change that unified the income tax treatment of equity joint ventures and foreign enterprises. It also considers the basic framework of tax incentive policies for FIEs and their positive role in promoting foreign investment in the 1990s. Third, the article considers China's accession to the World Trade Organisation (WTO). Finally, it discusses the new changes to the tax incentive policies and their influence on foreign investment.

BACKGROUND AND INITIAL PHASE (1980 - 1990)

Sovereigns have always used taxation preferences to regulate socio-economic conditions and achieve economic and political objectives. Tax preferences include exemptions, reductions, differential treatment. In China, tax preference for foreign investors appeared in the early 1980s as the nation opened its market to the world.

In the early 1980s, policies of market-oriented reform were being implemented nationwide, and economic development was becoming state policy. However, shortages of capital and technology obstructed the initial stages of reform. To attract international capital and encourage technological advancement and innovation, China chose a course of internationalization and opening its markets to the outside world.

China, however, was lumbered with a poor macro-investment environment. This included a weak industrial base, poor infrastructure, low-degree markets, inefficiencies of government, and an ineffective legal system. In addition, China poorly understood open markets, and this made foreign investors reluctant to become too involved. To attract large scale foreign investment, China chose a policy of 'concessions to promote the opening of the market'. Preferential tax treatment for

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foreign investors was seen as one means to compensate a poor investment environment.

In April 1980, the first joint venture of Beijing Air Catering Co Ltd was established. The enterprise investor, Wu Shuqing, a businesswoman from Hong Kong, received the first certificate of approval for Sino-foreign joint ventures from the Foreign Investment Management Committee. The approval brought a sense of honour but also uneasiness because of the absence of clear statements of tax rates or preferential policies for joint ventures and the lack of precedents.

To meet the tax demands of emerging Sino-foreign joint ventures, China promulgated the *Income Tax Law of the People's Republic of China on Chinese-foreign Equity Joint Ventures* (hereafter referred to as Law 1980) and its rules of implementation. The *Income Tax Law of the People's Republic of China on Foreign Enterprises* (hereafter referred to as Law 1981) and its rules of implementation were also successfully introduced in the next two years. Law 1981 applies to foreign enterprises with establishments in China engaged in independent business operations, or in cooperative production or cooperative business operations with Chinese enterprises.¹ The timely promulgation of these laws had an extremely important effect on foreign entrepreneurs by increasing predictability of taxation rates and thus encouraging investment in China.

Law 1980, Law 1981, the rules of implementation and regulations established the basic framework for preferential tax treatment and legislated principles governing foreign-related tax revenues, such as tax reductions and exemptions for FIEs located in special regions, called Special Economic Zones (SEZs).² These SEZs were categorised as (i) Economic and Technological Development Zones; (ii) Coastal Economic Open Zones; (iii) High-tech Industry Development Zones; and (iv) bonded areas. This formed a multi-layered taxation regime applying varying reductions and exemptions for FIEs depending on their operation within specific zones.³ Furthermore, FIEs engaged in specific industry projects were entitled to tax refunds

¹ Law 1981 article 1.

² *Guowuyuan Guanyu Jingji Tequ he Yanhai Shisi ge Gangkou Chengshi Jianzheng Mianzheng Qiye Suodeshui he Gongshang Tongyishui de Zanxing Guiding* (Guo Fa [1984] No 161) [trans: Provisional Regulations for Special Economic Zones and 14 Coastal Cities on Reduction and Exemption of Enterprises Income Tax and Consolidated Industrial and Commercial Tax by The State Council] (China).

³ Gao Peiyong, 'Yanbian zhong de Zhongguo Shuishou Youhui Zhengce' (1997) 8 *Shewai Shuiwu* 5-8 [trans: 'The evolution of China's foreign-related tax preferential policies' in *Foreign-related taxation*].

for reinvestment benefit⁴ and carry-over losses.⁵ This preferential treatment remained in place until the end of 2007.

In the 1980s, foreign investment greatly expanded to promote development of China's national economy. From 1979 to 1990, China attracted foreign direct investment contracts of \$US 40.615 billion and actual foreign direct investment of \$US 20.692 billion.⁶ In 1990, foreign direct investment accounted for 0.9 % of China's GDP and 6.3% of the total investment in fixed assets.⁷

SECOND STAGE: ACCELERATED INVESTMENT AND DEVELOPMENT

Legislation in 1990s: unified tax laws for FIEs

As more regions opened markets to the outside world and reforms deepened, foreign investment steadily increased in equity joint ventures, contractual joint ventures and FIEs. Meanwhile, policies of differential tax treatment for FIEs were under constant scrutiny.

Interestingly, compared with the contractual joint ventures and foreign enterprises, equity joint ventures enjoyed greater preferential tax treatment. For example, the income tax rate on equity joint ventures was 30% with a local income tax of 10% of assessed income tax (that is a further 3% on taxable income). However, the tax rate for FIEs was computed progressively on taxable income in excess of specified amounts. The result is a tax rate for FIEs ranging from 20% to 40%, with a 10% local income tax levy.⁸

Furthermore, all equity joint ventures, regardless of their nature, enjoyed a full two year tax holiday, followed by a three years reduction at 50% of the applicable tax rate. However, contractual joint ventures and foreign enterprises, which were limited to operating in agriculture, forestry, animal husbandry and other industries with low profit margins, could only enjoy a one year tax exemption and two years reduction on half rates. This kind of discrimination had a great negative effect on the enthusiasm of foreign investors.

⁴ Law 1980 article 6.

⁵ Law 1980 article 7, Law 1981 article 6.

⁶ National Bureau of Statistics of China, *China Statistical Yearbook (2007)* Table 18-14. <<http://www.stats.gov.cn/tjsj/ndsj/2007/html/R1814e.htm>> at 5 March 2008.

⁷ National Bureau of Statistics of China, *Zhongguo Tongji Nianjian (1991)* 18, 144 [trans:*China Statistical Yearbook*].

⁸ Law 1980 article 3, Law 1981 article 3.

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On 9 April 1991, the Seventh National People's Congress adopted the *Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises* (hereafter Law 1991), implemented a unified income tax law for equity joint ventures, contractual joint ventures and wholly foreign-owned enterprises. Law 1991 and the *Rules for the Implementation of the Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises* (hereafter Rules 1991) went in to effect from 1 July 1991.

The head of the State Administration of Taxation, JinXin, briefly introduced the new tax laws stating:

The promulgation and implementation of the new tax law, is not simply a merger of the *Income Tax Law on Chinese-foreign Equity Joint Ventures* and the *Income Tax Law on Foreign Enterprises* in a simple way, but is a turning point in the merging and reconstructing of tax policies related to foreign-invested enterprises in accordance with the social, political and economic changes in the situation.⁹

JinXin outlined three policy principles embodied in the new Law: first, to implement the policy of opening the Chinese economy to the outside world and the strategy of developing the economy to improve the investment environment as well as promote foreign economic and technological development; second, to continue to implement lower rates, more preferences and facilitated procedures on the basis of safeguarding national interests, and to focus preferential tax treatment measures on guiding the orientation of foreign investment towards encouraged industries; third, to combine the continuity, stability and adaptability of the tax law on the basis of China's actual situation and international practice.¹⁰

In the new Law a series of tax incentives were given to FIEs. These incentives played an important role in attracting foreign investment, introducing advanced technology and promoting economic construction. The contractual value of using foreign direct investment reached \$US 11.977 billion in 1991, an increase of 81.47 % over that of 1990; the amount of foreign capital actually used reached \$US 4.366 billion, an increase of 25.21%.¹¹ The value of investment significantly increased in the subsequent two years. The contractual value of using FDI is \$US 58.124 billion in 1992 and \$US 111.436 billion in 1993, respectively an increase 385.29 % and 91.72% over the previous year.¹²

⁹ LinHong, above n 1.

¹⁰ Ibid.

¹¹ See National Bureau of Statistics of China, *Zhongguo Tongji Nianjian* (1995) 554 [trans:China Statistical Yearbook].

¹² Ibid.

While the average growth rate of foreign capital 1986 to 1990 was only 6.06%, foreign capital actually utilized in 1992 amounted to \$US 11.007 billion and \$US 27.515 billion in 1993, a respective increase of 152.10% and 149.97 % over the previous year.¹³ China's actual use of foreign capital only had an average growth rate of 12.97% from 1986 to 1990, proving that preferential tax policies were an effective means of attracting foreign investment.

Tax incentives in 1990s

1 Lower rates

Nominal tax rate on FIEs was 30% (with a further local income tax computed on the taxable income at a rate of 3%), but a reduced rate can be applied to those located in regions specially designated or related with specific projects. Law 1991 and subsequent legislation specified that:

(a) A 15% income tax rate would apply to the following foreign-funded enterprises:

- FIEs located in SEZs, Foreign Enterprises with establishments or business offices in SEZs engaged in production and business operations, as well as those FIEs engaged in production which had establishments in Economic and Technological Development Zones;¹⁴
- FIEs engaged in production which were located in the old urban districts of cities within the SEZs, the Coastal Economic Open Zones, the Economic Technological Development Zones, and which were engaged in technologically intensive or knowledge intensive projects, or foreign invested projects with an amount of

¹³ Ibid.

¹⁴ Law 1991 article 7 s 1; Rules 1991 article 69, article 71 s 1. A 15% income tax rate applied to enterprises located in Shenzhen, Zhuhai, Shantou, Xiamen, Hainan SEZs and to enterprises invested by Taiwan businessmen in Xiamen Taiwan Businessmen Investment Area. See also *Guangdong Sheng Jingji Tequ Tiaoli* [trans:Regulation on Special Economic Zones of Guangdong Province] (China), *Dui Fujian Sheng Guanyu Jianli Xiamen Jingji Tequ de Pifu* (Guo Han [1980] No 88) [trans:Reply to Fujian Province on the Construction of Xiamen Special Economic Zone](China), *Guowuyuan Guanyu Guli Touzi Kaifa Hainandao de Guiding* (Guo Fa [1988] No 26) [trans: Provisions of the State Council on Encouraging Investments to the Development of Hainan Island](China) and *Guowuyuan Guanyu zai Fujian Sheng Yanhai Diqu Sheli Taishang Touziqu de Pifu* (Guo Han [1989] No 35) [trans:Reply of the State Council on the Establishment of Taiwan Businessmen Investment Areas in the Coastal Areas of Fujian Province].

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investment of more than US\$ 30 million and a long capital recovery time, or engaged in energy sources, transportation and port constructions;¹⁵

- Foreign-Chinese Equity Joint Ventures engaged in the construction of ports and docks;¹⁶
- Foreign capital banks and Foreign-Chinese Joint Invested Banks and other financial institutions located in the SEZs or other areas approved by the State Council, where the capital provided by foreign investors or the funds for business activities allocated by the head office bank to the branch bank exceeds US \$10 million; and at the same time with an operational period of ten years or more;¹⁷
- FIEs engaged in production set up in the Pudong New District of Shanghai, and FIEs engaged in energy exploitation and transportation construction projects such as airports, ports, railways, highways, and electricity power stations;¹⁸
- Accredited high technological FIEs set up in New and High-Technology Industrial Development Zones identified by the State Council; or accredited new technological FIEs situated in Beijing New Technology Development and Experiment Zones;¹⁹

¹⁵ Law 1991 article 7 s 3; Rules 1991 article 73 s 1(1). Favoured areas extended to capital cities and open riparian cities in *Notification of the State Council on Further Opening Nanning, Chongqing, Huangshi, Yangtze Three Gorges Economic Development Zone, Beijing and other cities*, see Guo Han [1992] No 62, Guo Han [1992] No 93, Guo Han [1993] No 19, Guo Han [1994] No 92, Guo Han [1995] No 16. Concession to energy sources, transportation and port constructions expanded to nationwide in 1999, see also *Guowuyuan Guanyu Kuoda Waishang Touzi Qiye Congshi Nengyuan Jiaotong Jichu Sheshi Xianmu Shuishou Youhui Guiding Shiyong Fanwei de Tongzhi* (Guo Fa [1999] No13) [trans: *Circular of the State Council on Expanding the Scope of Application of the Preferential Tax Provision to Foreign-invested Enterprises Engaged in Infrastructure Projects of Energy and Traffic*] (China).

¹⁶ Rules 1991 article 73 s 1(2).

¹⁷ *Ibid*, article 73 s 1(3).

¹⁸ *Ibid*, article 73 s 1(4). Concessions to FIEs engaged in production at the reduced rate of 15% extended to which situated in other coastal cities or areas such as Fuzhou Taiwan Businessmen Investment Area, Shanghai Waigaoqiao, Tianjin Port, Shenzhen Futian, Shenzhen Shaotoujiao, Dalian, Guangzhou, Xiamen Xiangyu, Zhangjiagang, Haikou, Qingdao, Ningbo, Fuzhou, Shantou, Zhuhai, Shenzhen Yantian Bonded Areas and Suzhou Industrial Park, see Guo Han [1989] No 35, Guo Han [1991] No26, Guo Han [1991] No 32, Guo Han [1992] No 43, Guo Han [1992] No 44, Guo Han [1992] No 148, Guo Han [1992] No 150, Guo Han [1992] No 159, Guo Han [1992] No 179, Guo Han [1992] No 18, Guo Han [1992] No 181, Guo Han [1993] No 3 and Guo Han [1994] No 9.

¹⁹ S, Rules 1991 article 73 s 1(5).

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- FIEs established in other places specified by the State council and engaged in such projects as encouraged by the State;²⁰ and
- FIEs engaged in encouraged projects established in western regions of China during 2001-2010.²¹

(b) The following enterprises and projects will be eligible for taxation on enterprise income at 24%:

- FIEs engaged in production situated in Coastal Economic Open Zones or in the old urban districts of cities in the SEZs or the Economic and Technological Development Zones;²²
- FIEs engaged in production situated in coastal port cities, provincial capitals cities, open riparian cities, the border economic cooperation zones and the border cities of China;²³ and
- FIEs situated in national tourist vacation areas which approved by the State Council.²⁴

2 Fixed term tax exemptions and reductions

(a) Initial and start up incentives

²⁰ Rules 1991 article 73 s 1(6).

²¹ *Caizhengbu, Guojia Shuiwu Zongju, Haiguan Zongshu Guanyu Xibu Dakaifa Shuishou Youhui Zhengce de Tongzhi* (Cai Shui [2001] No 202, issued on 30 December 1999) [trans: Notification of the Ministry of Finance, State Administration of Taxation and General Administration of Customs on the Preferential Policies for Western Development Program with regard to Enterprise Income Tax](China). This refers to those enterprises whose main businesses are included in the encouraged category as stipulated in *Catalogue for the Guidance of Foreign Investment Industries* and among the industries as stipulated in *Catalogue of Dominant Industries for the Foreign Investment in Central and West China* and whose income from the main businesses comprises over 70% of the total enterprise income.

²² Law1991 article 7 s 2; Rules 1991 article 70, article 71 s 2.

²³ Guo Han [1992] No 21, Guo Han [1992] No 61, Guo Han [1992] No 62, Guo Han [1992] No 93, Guo Han [1992] No 94, Guo Han [1993] No 19, Guo Han [1994] No 92 and Guo Han [1995] No 16.

²⁴ *Guowuyuan Guanyu Shibao Guojia Luyou Dujiaqu Youguan Wenti de Tongzhi* (Guo Fa [1992] No 46)[trans: *Notification of the State Council on the Pilot Project for National Tourist Vacation Areas*] (China).

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Besides the reduced-rate concession under Law 1991, fixed term tax exemptions and reductions apply to qualified foreign-funded enterprises from the first profit-making year.²⁵

(i) The following enterprises shall be exempted from income tax for five consecutive years followed by a further five years at a 50% tax reduction:

- Any Chinese-foreign equity joint venture undertaking port or dock construction with an operational period exceeding 15 years, upon its application having been endorsed by the competent tax authorities at the provincial level;²⁶
- Any FIE established in Hainan SEZ with an operational period no less than 15 years, and which is engaged in construction of infrastructure or in the development and operation of agriculture;²⁷
- Any FIE established in the Pudong New District of Shanghai, with an operational period no less than 15 years and undertaking the construction of energy and communication projects.²⁸

(ii) A two year exemption followed by three years at a 50% reduction applies to:

- Any FIE engaged in production intended to conduct business in China for at least 10 years;²⁹
- Any FIE engages in an encouraged category of projects in the *Catalogue for the Guidance of Foreign Investment Industries* approved by the State Council and which meets any of the following conditions (the investor may, with regard to the proceeds from investment items beyond the original contract, separately calculate and enjoy a regularly reduced or exempted enterprise income tax preferential treatment):
 - the newly-increased amount of registered capital due to the increase of investment is no less than US\$ 60 million; or

²⁵ 'The first profit-making year' means the first tax year in which profits are obtained by an enterprise following commencement of production or business operations. Where an enterprise suffers losses during the early stages after establishment, the first profit-making year shall be the year in which profits are obtained after such losses are made up by the income of the following tax year. See SRules 1991 article 76, s 1.

²⁶ Law 1991 article 8 s 2, Rules 1991 article 75 s 1(1).

²⁷ Rules 1991 article 75 s 1(2).

²⁸ Ibid article 75 s 1(3).

²⁹ Law 1991 article 8 s 1, Rules 1991 article 78, article 74 s 2.

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- the newly-increased amount of registered capital due to the increase of investment is no less than US\$ 15 million, and also no less than 50% of the enterprise's original registered capital;³⁰

- Newly-established FIEs with a prospective operational period of more than 10 years in transportation, power generating, water conservancy, postal service, radio broadcasting and television.³¹

(iii) A two year exemption applies to:

Any Sino-foreign equity joint venture recognized as a new and high-technology enterprise and established in new and high-technology industrial development zones approved by the State Council or located in SEZs and in the Economic Technology Development Zones with an operational period exceeding 10 years;³²

(iv) The following enterprises shall be exempted from income tax for the first profit-making year, followed by a further two years at a 50% tax reduction:

- FIEs in the service sector situated in SEZs, with a total foreign investment amounting to US \$5 million or more, and with its operation period exceeding 10 years;³³
- Financial institutions such as foreign capital banks and Sino-foreign banks established in the SEZs and other areas approved by the State Council where the capital contribution of the foreign investor or the funds for business activities allocated by the head office bank to the branch bank exceeds US \$10 million and with a prospective operational period of no less than ten years.³⁴

³⁰ *Caizhengbu, Guojia Shuiwu Zongju Guanyu Waishang Touzi Qiye Zuijia Touzi Xiangshou Qiye Suodeshui Youhui Zhengce de Tongzhi* (Cai shui [2002] No 56)[trans: *Circular of the Ministry of Finance and the State Administration of Taxation on Enterprise Income Tax Preferential Polices to Be Enjoyed by Enterprises with Foreign Investment Which Increase Investments*] (China).

³¹ *Caizhengbu, Guojia Shuiwu Zongju, Haiguan Zongshu Guanyu Xibu Dakaifa Shuishou Youhui Zhengce Wenti de Tongzhi* (Cai Shui [2001] No 202) [trans: *Notification of the Ministry of Finance, State Administration of Taxation and General Administration of Customs on the Preferential Policies for Western Development Program with regard to Enterprise Income Tax*] (China).

³² Rules 1991 article 75 s 1(6). See also *Guowuyuan Guanyu Shishi 'Guojia ZhongChangqi Kexue he Jishu Fazhan Wenti Gangyao(2006-2020 Nian)' Ruogan Peitao Zhengce de Tongzhi* (No 6, 2006 of the State Council) [trans: *Notification of the State Council on Carrying out the Several Supporting Policies regarding National Outlines for Medium and Long-term Planning for Scientific and Technological Development (2006-2020)*](China).

³³ Rules 1991 article 75 s 1(4).

³⁴ *Ibid* article 75 s 1(5).

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(b) Industrial incentives

(i) Special concession for export-oriented FIEs

After the expiration of exemption or reduction stated in the Law 1991, export-oriented FIEs shall be entitled to a further 50% reduction on Enterprise Income Tax at a rate specified in the Law 1991, provided that at least 70% of their annual products have been exported.³⁵

(ii) Special concession for technological advanced enterprises with foreign investment

Upon the expiration of the Enterprise Income Tax exemption and reduction period as stipulated by the Tax Law, those shall enjoy a further 50% reduction in Enterprise Income Tax for three years based on the rate stipulated by the Tax Law, provided that they remain technologically advanced enterprises.³⁶

(iii) Tax incentives concerning agriculture, forestry, animal husbandry, and tax incentives in remote undeveloped areas

FIEs engaged in agriculture, forestry, stock raising or located in the remote economically underdeveloped areas, after the period of enjoying favourable tax policies expires, shall be subject to an income-tax rate of 15% to 30% in the following 10 years.³⁷

3 *Tax refunds on reinvestment*

(a) 40% refund

A refund of 40% is applicable to income tax that has been paid on the reinvestment amount for foreign investors who reinvest their share of profits directly in the same FIEs so as to increase registered capital, or use their share of profits as capital investment to set up other FIEs with an operational period no less than 5 years.³⁸

(b) 100% refund

A refund of the entire amount of income tax paid on the reinvestment sum applies to direct reinvestment by foreign investors for the organization and expansion of export oriented enterprises or advanced technology enterprises, as well as profits earned by foreign investors in enterprises established in the Hainan SEZ that are directly

³⁵ Rules 1991 article 75 s 1(7).

³⁶ Ibid article 75 s 1(8).

³⁷ Law 1991 article 8 s 3.

³⁸ Ibid Article 10.

reinvested in the Hainan SEZ in infrastructure projects and agriculture development enterprises.³⁹

4 Other tax incentives

(a) Tax exemptions for long-term investment

Where an FIE invests in another enterprise within China, the profits (dividends) obtained from the enterprise receiving the investment may be excluded from the taxable income of that FIE.⁴⁰

(b) Deduction of research & development (R&D) expenses from taxable income

Any FIEs where R&D expenses has increased by over 10% (including 10%) than that for the previous year, shall be permitted, upon examination and approval by the taxation authorities, to re-offset 50% of the amount actually used for R&D expenses for the taxable income for the same year.⁴¹

(c) Income tax credit for investment in purchased domestic equipment

For any FIE established in China, 40% of its investment in purchasing domestic equipment may be refundable from the increased part of its enterprise income taxes of the purchasing year over those of the year before, if the equipment falls under the *Encouraged Category and Restricted B Category listed in the Directive Category of the Industries of Enterprises with Foreign Investment* or for the purpose of improving existing equipment, manufacturing techniques and conditions with advanced and suitable new technologies, craftwork, equipments and materials to increase economic benefit, improve product quality, enhance comprehensive resource utilizations and waste control and ensure labour protection and safety.⁴²

(d) Exemption from withholding tax

(i) The withholding tax of 20% on foreign enterprise will be waived for:

³⁹ Rules 1991 article 81 s 1.

⁴⁰ Ibid Article 18.

⁴¹ *Guojia Shuiwu Zongju Guanyu Waishang Touzi Qiye Jishu Kaifafei Dikou YingNashui Suode E Youguan Wenti de Tongzhi* (Guo Shui Fa [1999] No 173) [trans: *Circular of the State Administration of Taxation on the Issues Related with the Offset Taxable Income on Technology Development Fee of Enterprises with Foreign Investment*](China).

⁴² *Caizhengbu, Guojia Shuiwu Zongju Guanyu Waishang Touzi Qiye Goumai Guochan Shebei Touzi Dimian Qiye Suodeshui Youguan Wenti de Tongzhi* (Cai Shui Zi [2000] No 49) [trans: *Circular of the Ministry of Finance and the State Administration of Taxation Concerning the Issue of Tax Credit for Business Income Tax for Homemade Equipment Purchased by Enterprises with Foreign Investment and Foreign Enterprises*] (China).

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- the profit derived by a foreign investor from an enterprise with foreign investment;
- income from interest on loans made to the Chinese government or Chinese state banks by international financial organizations;
- income from interest on loans made at a preferential interest rate to Chinese state banks by foreign banks.⁴³

(ii) A reduced rate of 10% will be levied upon:

- Royalties received for the supply of technical know-how in scientific research, exploitation of energy resources, development of communication industries, agricultural, forestry and animal husbandry production, and the development of important technologies;⁴⁴ and
- FIEs which have no institutions and premises in China or which have set up institutions and premises that have no practical connection with their income, are liable to business income tax upon their interest, rent, royalties and other income at 10% from January 1, 2000.⁴⁵

(e) Tax deduction

Where an enterprise with foreign investment or a foreign enterprise provides scientific research institutions and schools of higher education with funds for research and development, the funds may be totally deducted from the taxable income of the supporting enterprise.⁴⁶

⁴³ Law 1991 article 19 ss 3(1), (2) and (3).

⁴⁴ Ibid article 19 s 3(4).

⁴⁵ *Guowuyuan Guanyu Waiguo Qiye Laiyuan yu Woguo Jingnei de Lixi deng Suode Jianzheng Suodeshui Wenti de Tongzhi* (Guo Fa [2000] No 37)[trans: *Circular of the State Council on Income Tax Reduction on Foreign Enterprise Income from Interest Etc. Originated in China*](China).

⁴⁶ Article 4 in *Caizhengbu, Guojia Shuiwu Zongju Guanyu Guance Luoshi 'Zhonggong Zhongyang, Guowuyuan Guanyu Jiaqiang Jishu Chuangxin, Fazhang GaoKeji, Shixian Chanyehua de Jueding' Youguan Shuishou Wenti de Tongzhi* (Cai Shui Zi [1999] No 273) [trans: *Circular of The Ministry of Finance And The State Administration of Taxation on Tax Issues Related to The Implementation of The Decision of The Chinese Communist Party Central Committee And The State Council on Strengthening Technical Innovation, Development of High-tech and Realization of Its Industrialization*](China).

5 *Concessions and exemptions for local income tax*

For FIEs engaged in industries or undertake projects encouraged by the State, governments at the provincial level are authorized to decide whether or not to give those FIEs concessions or exemptions on local income tax.⁴⁷ To attract foreign investment and develop the local economy, nearly all local governments abandoned local income tax on FIEs.⁴⁸

CHARACTERISTICS OF 1990S TAX INCENTIVES

China's preferential tax policies for foreign investment are obviously a 'super-national treatment',⁴⁹ and show the following characteristics: First, the legal entities with tax preferences are widespread so long as they are foreign-related enterprises regardless of regions, industries, and technical sophistication. Second, regionally based benefits are more widespread than industrial and technical benefits, and are more concentrated in the coastal regions. Inland areas enjoy limited preferences with broad benefits available only for specific locations and manufacturing industries. Third, categories of tax concessions are poorly planned, overlapping and ill co-ordinated. Tax benefits occur at different levels of governments and often have complex levels causing confusion and overlap in many areas.

THE POSITIVE EFFECT OF TAX INCENTIVES

1 *Attracting foreign investment*

FIEs in China did not exist in the early 1980s and flourished to play a decisive role in China's rapid economic growth. By 2007, 274,863 FIEs had been registered nationwide⁵⁰ and the contractual value of foreign funds amounted to US\$1,485.848

⁴⁷ Law 1991 article 9.

⁴⁸ See, eg, *Regulations of Concessions and Exemptions for local income tax on FIEs* issued by Government of Jiangxi Province, Jiangsu Province, Zhejiang Province, Hebei Province, Chongqing, Dalian, Guangzhou, etc.

⁴⁹ The national treatment is one of the main legal standards used in international practice for foreign direct investments, which means that foreign investors and their investments should be treated equally as domestic ones in like circumstances. It has been specified in GATT-WTO clauses and gradually made into domestic legislation. Some scholars hold that the national treatment requires that the taxation treatment enjoyed by the foreign enterprises is neither lower than the national residents nor higher than the national residents. Super-national treatment of taxation existed in China because FIEs can enjoyed more tax preferential policies. See Kongxia, *Unifying the Income Tax* (2005) Finance and Tax Law of China <http://www1.cntl.cn/show.asp?c_id=4&a_id=4833> at 28 March 2008.

⁵⁰ National Bureau of Statistics of China, *China Statistical Yearbook* (2007) table 18-18 (2008)

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billion (actual utilized value US\$691.897 billion). Other foreign investment amounted to US\$43.680 billion (utilized value US\$43.619 billion) as shown in Table 1.⁵¹ In 2007, 37,888 foreign invested enterprises were established and the value of utilized foreign fund was US\$82.658 million, an increase of 13.8% year-on-year.⁵²

At the beginning of the reform and opening up in 1980, China's foreign-related tax revenue was only CNY 1 million, accounting for only 0.02% of the total tax revenue.⁵³ After 10 years, China's foreign-related tax revenue reached CNY 4.915 billion, accounting for 2.5% of the total tax revenue in 1990.⁵⁴ Tax revenue paid by FIEs has constantly improved as a percentage of total income tax revenue. In 1994, income tax raised through FIES was CNY 40.264 billion, accounting for 8.51% of the general income tax revenue.⁵⁵ By 2006, it amounted to CNY 797.693 billion, accounting for 21% of gross income tax.⁵⁶

In the short term, China gave up a part of its tax revenues through preferential tax treatment, but in the long-term it brought continuous inflow of foreign capital and revenue from FIEs. The quantity of FIEs greatly increased and became an important part of China's fiscal revenue.

TABLE 1: UTILIZATION OF FOREIGN CAPITAL

(unit) (USD 100 million)

Year	Direct Foreign Investments			Other Foreign Investment	
	Number of Projects	Contracted	Actually	Contracted	Actually
		Value	Utilized	Value	Utilized

<<http://www.stats.gov.cn/tjsj/ndsj/2007/html/R1818e.htm>> at 5 March 2008.

⁵¹ National Bureau of Statistics of China, above n 8. Data was edited by the author.

⁵² See Ministry of Commerce of China, *Statistics of foreign investment in 2007* (2008) <<http://www.mofcom.gov.cn/aarticle/tongjiziliao/v/200801/20080105347470.html>> at 20 March 2008.

⁵³ LinHong, above n 1.

⁵⁴ Ibid.

⁵⁵ See Chinese Academy of International Trade and Economic Cooperation, 'Statistics of China's Foreign-related Tax Revenue (Excluding Customs Duty and Land Fees) from 1992 to 2006' in *China Commerce Yearbook 2007*. The data also available at <http://tjsj.baidu.com/pages/jxyd/24/74/8899ce8f0e08c52f7245cab8ef081b94_0.html> at 20 April 2008.

⁵⁶ Ibid.

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1979-1984	3724	97.50	41.04	13.98	10.42
1985	3073	63.33	19.56	4.02	2.98
1986	1498	33.30	22.44	4.96	3.70
1987	2233	37.09	23.14	6.10	3.33
1988	5945	52.97	31.94	8.94	5.45
1989	5779	56.00	33.93	6.94	3.81
1990	7273	65.96	34.87	3.91	2.68
1991	12978	119.77	43.66	4.45	3.00
1992	48746	581.24	110.08	6.12	2.84
1993	83437	1114.36	275.15	5.31	2.56
1994	47594	826.80	337.67	4.08	1.79
1995	37011	912.82	375.21	6.35	2.85
1996	24556	732.76	417.26	3.71	4.10
1997	21001	510.03	452.57	41.82	71.30
1998	19799	521.02	454.63	27.14	20.94
1999	16918	412.23	403.19	24.26	21.28
2000	22347	623.80	407.15	87.50	86.41
2001	26140	691.95	468.78	27.81	27.94
2002	34171	827.68	527.43	19.82	22.68
2003	41081	1150.70	535.05	18.32	26.35
2004	43664	1534.79	606.30	31.09	34.42

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2005	44001	1890.65	603.25	35.28	34.80
2006	41485	2001.74	694.68	44.89	40.55
Total Amount	594427	14858.48	6918.97	436.80	436.19

2 Introducing advanced technology and management experience

In China, there is an urgent need for advanced technology and management experience for China's drive to modernization. China's tax preference policies, such as relatively low tax rates and generous tax incentives, appeal to foreign investors. This results in large inflows of foreign capital and introduces China to the advancements technology and scientific management.

The influx of FIEs to China began in the textile industry and expanded to industries for household appliances and then to other light industries flourished. The production of computer installation kits and accessories provides a foundation for high-tech industries. In the automotive industries The Shanghai-Volkswagen Automotive Company and Beijing Jeep Corporation lifted the technical level of China's car industry. Foreign investment stimulated rapid industrial renovation and upgrading and directly established and promoted new industries.

3 Accelerating China's economic reform process

FIEs provided a modern enterprise reference for building a market-based economy in China. Because FIEs are firmly based on market-economy principles and practice effective cost management, marketing management and human resource strategies, they not only provide domestic enterprises with experience, but they also expand the national vision. Chinese businesses are able to gain an understanding of the customary rules in international transactions, and generate new ideas and concepts for conducting international business and transactions. These experiences drove economic reform and the reshaping of China's micro-economic system.

The policies that opened China's markets to foreign enterprises catalysed the development of China's market economy and marked the end of the planned economy. Opening to the outside world means that domestic economic entities must trade and operate within an international business environment, and allocate

resources according to international common practice. This has brought about a series of market-oriented reforms in China.⁵⁷

4 Promoting export growth and employment

Since 1994, China's foreign trade has maintained a high rate of growth each year. In 1994, China's exports were US\$ 121.01 billion, but this increased rapidly to US\$ 1,218.01 billion in 2007. This was largely due to a rapid increase in exports by FIEs.⁵⁸ China's exports by FIEs were US\$ 34.7 billion in 1994, increasing to US\$ 695.52 billion in 2007. This accounted for 28% of the country's total exports in 1994. This increased to 57% in 2007.⁵⁹ In some years, FIEs contribution to the increase in exports was greater than 100%. In other words, China's annual export growth would have been negative without the contribution of the FIEs.⁶⁰

Moreover, foreign direct investment created a large number of employment opportunities in China to the extent that more than 27 million people were employed directly in FIEs by the end of 2006. This accounted for 9.5% of the labour force in Chinese cities and towns.⁶¹

NEGATIVE EFFECTS OF TAX INCENTIVES: REASONS FOR CHANGE

A Unfairness arising from the dual tax system

Most countries have unified tax laws imposing the same tax burden on all taxpayers. However, differential treatment for foreign investors is often reflected in the specific

⁵⁷ Gao Peiyong, above n 7.

⁵⁸ Ministry of Commerce of China, *Import and Export since 1978* (2004) <<http://zhs.mofcom.gov.cn/aarticle/Nocategory/200405/20040500218163.html>> and *Import and Export Mix in 2007* (2008) <<http://zhs2.mofcom.gov.cn/aarticle/ie/statistic/200802/20080205367271.html>> at 20 May 2008.

⁵⁹ National Bureau of Statistics of China, *China Statistical Yearbook* (1996) Table 16-12 <<http://www.stats.gov.cn/nds/j/information/zh1/p121a>> and Ministry of Commerce of China, *Export of Provinces and Cities by Type of Enterprises in 2007* (2008) <<http://zhs2.mofcom.gov.cn/aarticle/ie/statistic/200802/20080205367241.html>> at 5 March 2008. Percentages were calculated by the author.

⁶⁰ LinHong, above n 1.

⁶¹ Li Xinxin, *Fei Gong Jingji Fazhan Zhibiao Bizhong Da Zeng* (2007) [trans: *Great Development of Non-public owned Economies*] China Economic Net <http://www.ce.cn/xwzx/gnsz/gdxw/200710/01/t20071001_13111941.shtml> at 23 April 2008.

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implementation of certain tax laws, or in foreign investment laws. China by contrast, has special legislation regulating the tax treatment of domestic and foreign enterprises differently. The result of this dual system is 'tax discrimination' to the detriment of domestic enterprises. For example, the nominal income tax rate on both kinds of enterprise is 33%, but FIEs which are located in specific areas, such as SEZs and economic or technological development zones, can enjoy a reduced rate of 24%, 15% or even 10%, depending on their locations or industries.

Furthermore, FIEs enjoy more favourable policies on disposition of assets, tax rebates, etc. For example, the tax holiday for a new business is a two year tax exemption followed by a 50% reduction for the following three years. These concessions take effect from the first year of operation for domestic firms, but commence for FIEs in the first year in which they make profits. A national survey estimates that the average income tax burden on FIEs is 15 %, while that on domestic enterprises is 25 %.⁶²

Although these provisions enabling FIEs to enjoy 'super-national treatment' are not opposed or prohibited by national legislation, nor by bilateral or multilateral investment agreements or the WTO rules, they super-national treatment became an obstacle to fair competition and rational allocation of resources to enterprises. Therefore, the costs for domestic enterprises are higher, forcing them to compete with FIEs on equal terms.⁶³

Fair competition is one of the basic concepts of any market economy. The economy must be well regulated and provide equal competition amongst all firms operating within the market. Applying different tax treatment to entities based on ownership, source of investment, location, or the nature of business, hinders the pursuit of fair competition.⁶⁴ Differential tax treatment in China handicapped the drive for fair competition on the market.

With China's accession to the WTO, the domestic market has been further opened to foreign capital. Domestic enterprises have gradually integrated themselves into the world economy and face ever increasing competition. If different tax policies continue for domestic enterprises and FIEs, the former will be competitively disadvantaged

⁶² Jin Renqing, *Guanyu Zhonghua Renmin Gongheguo Qiye Suodeshui Fa Cao'an de Shuoming* (2007) [trans: Explanation on China's draft enterprise income tax law] The Central People's Government of the PRC <http://www.gov.cn/2007lh/content_545816.htm> at 12 March 2008.

⁶³ Gao Peiyong, above n 7.

⁶⁴ Wang Xiao Min, 'Zhongguo Shewai Shuishou Youhui Zhengce de Deshi Ji Qi Gaige' (1997)3 *Fa Shang Yanjiu* 45-50 [trans: 'China's foreign-related tax preferential policies and the pros and cons of the reform' in *Studies in Law and Business*].

and the establishment of a unified market with standardized and fair competition will be obstructed.⁶⁵ This is also a long term deterrent to the development and survival of national industries.

Lastly, as a member of the WTO, China is obliged to increasingly open more service sectors to the outside by the end of their transition period. However, few of these service sectors will enjoy the tax concession provided to manufacturing enterprises. There is also a need to balance the tax treatment of FIEs engaged in different sectors.

B Unclear objectives and confusion with aims

Judging from the structure of the tax incentives in China, it is obvious that FIEs receive more universal concessions focusing on manufacturing enterprises, export orientated enterprises and regional-based enterprises. For example, all industries in SEZs enjoy reduced tax rates, and all enterprises engaged in production benefit from the same concessions, regardless of their size or industry type. This rather simple industrial oriented preferential policy leads to an irrational industrial structure for foreign investment, and relatively poor quality foreign investment. Such FIEs are mostly labour intensive rather than technology or capital intensive; however, the stated purpose of the SEZs is to promote accelerated development of advanced technology in China. The purpose is not to provide wider employment opportunities. A clearly stated objective could provide a foundation for the implementation of preferential policies to support specific industries and sectors, and guide the inflow of funds.

The basic purpose of foreign investment is to make profit and dictate the direction of investment. FIEs generally tend to invest in projects with a short operating-cycle, instant productivity and high profitability. They also like to enjoy the benefits of short term profits and tax incentives. Therefore, industries requiring large-scale investment, long operating cycles and long start up times, such as energy, transport, wharves, other infrastructure and high-tech industries, attract little foreign investment.⁶⁶

The initial goal of China's tax incentives was to attract foreign investment at the beginning of the opening of the market. The goal must now be to attract rational foreign investment, develop forestry, animal husbandry, fisheries, and other backward industries, and attract investment to bottleneck industries such as energy,

⁶⁵ Jin Renqing, above n 64.

⁶⁶ Zheng Guohong, *Zhongguo Waishang Touzi Shuishou Youhui Zhidi Chonggou Yanjiu* [trans: *A Probe into the Reconstruction of the Tax Incentives on Foreign Investment in China*] (2006) Finance and Tax Law of China <http://www.cftl.cn/show.asp?c_id=622&a_id=6060> at 18 March 2008.

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transportation and raw materials. Technology-intensive and capital-intensive industries also need developing, if China is to achieve its aims of industrial upgrading and structural adjustment.

However, China's past foreign-related tax concessions only gave special privileges to a few encouraged. It allowed only rigid and uniform concessions in other industrial sectors regardless of their nature. The tax incentives scheme did not attach sufficient importance to high-tech industries and underdeveloped economic areas, and did not have a gravitational effect on technology intensive and capital intensive industries. This brought about difficulties in the coordinated development of the national economy and the upgrading of industrial structure. As a result, China weakened the country's overall economic strength and damaged the country's economic security.

C Inefficiency and lack of practical benefit

Specific forms of preferential tax policies are used to reduce the burden of various types of taxation, including: tax exemptions, lower tax rates, accelerated depreciation, loss carry-overs, tax deductions, re-investment tax rebates, investment credits, deferred payments, expanding the scope of allowable deductions, and so on. Of these preferential methods, accelerated depreciation, loss carry-overs, tax deductions and re-investment tax rebates etc, are indirect concessions and are not restricted by international tax revenue factors. They also play an independent role in attracting foreign investment directly benefiting cross-border taxpayers.⁶⁷

Many of China's preferential tax policies focus on direct concessions, with the emphasis on tax reductions and low tax rates. Few policies provide indirect preferential benefits. This means that more profits are repatriated, unless exempted by bilateral taxation agreements. Without a tax sparing credit clause in bilateral taxation agreements, capital exporting country may have a high base on which to levy domestic taxes. China's tax concessions are therefore effectively subsidising foreign governments rather than foreign investors.

Whether tax exemptions and low tax rates play a role in reducing the tax burden on foreign depends on the taxation system of the capital exporting country. Most western countries, such as the USA, implement ordinary tax credit instead of tax sparing credit. Tax credit counterbalances the effect of the host country's preferential tax treatment. Any tax reductions by the host country will be directly transformed into tax revenue to the capital exporting country. By contrast, in the case of a tax sparing credit, the home country grants a certain credit notwithstanding the fact that the

⁶⁷ Wang Xiaomin, above n 66.

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foreign withholding tax actually paid is lower. As a result, the reduction of tax by the host country to attract foreign investments, capital, technology, etc is not frustrated.

The target of foreign-related tax preferential policies is to encourage cross-border investment. Only when the Chinese government enters into an International Tax Sparing Credit Agreement with the investors' country of residence, and only when China exempts investors from domestic taxes equal to the amounts forgiven by China, will foreign investors fully enjoy the tax preference. Only then will the preferential policies be fully effective.

D Disparities between regions

Although China grants tax incentives to FIEs in all areas, different levels of concessions apply in SEZs, economic and technological development zones, the coastal open economic zones, and other specific areas. Thus a ladder-like income tax rate has evolved whereby the tax rate becomes higher as one moves from SEZs to coastal economic development zones and further west to common inland regions.⁶⁸

Due to historical and geographic factors, there has been considerable economic disparity between the eastern and western parts of China. The eastern regions had convenient transportation and developed information sources which gave them considerable advantages for development. By contrast, the western areas had poor natural conditions, weak infrastructure, and undeveloped information systems which blocked economic development.⁶⁹ The differential tax preference policies in eastern coastal areas also contributed to unfair competition, which further enlarged the economic polarization between eastern coastal areas and the middle and western inland areas. Development of the national economy and regional stability have been unbalanced.

In recent years, national government policy in China has supported western development. Western China is now enjoying more support than the eastern part through preferential policies. However, because of the poor natural conditions and infrastructure, the west is still not able to compete with the east. Despite preferential policies on investment, the west still cannot effectively attract capital away from the east.⁷⁰ For instance, among the National Economic and Technological Development Zones, 32 are located in the eastern part of China, 9 in the middle of China and 13 in the west, but there is a wide gap between them in attracting foreign funds. Of actual

⁶⁸ Liu Jianwen, *Basic Thoughts on Reform of China Income Tax Laws* (2005) Finance and Tax Law of China <http://www.cftl.cn/show.asp?c_id=555&a_id=3854> at 12 March 2008.

⁶⁹ Gao Peiyong, above n 7.

⁷⁰ Liu Jianwen, above n 70.

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utilized value in 2007, US\$ 14,047.22 million was in the east, US\$ 2,131.68 million was in the middle of China and only US\$ 1,142.22 million was in the west.⁷¹ To a great extent, non-national tax treatment has led to a lopsided pattern of investment.

E Loss of state income

Massive foreign tax preferences brought about a loss of revenue in two ways. On the one hand, a large number of tax holidays and reductions seriously eroded the tax base significantly reducing revenue. Foreign-funded enterprises contributed to the tax income disproportionately according to their scale. On the other hand, some loopholes in these complicated tax preference policies stimulated an increase in tax evasion and tax avoidance resulting in outflows of state income as well as difficulties in tax revenue collection. For example, in order to attract the advantages given to foreign companies, some domestic enterprises and individuals transferred their funds to companies that were registered in offshore jurisdictions. They then invested their funds back to China, thus qualifying for favourable tax rates and tax incentives.

According to statistical data of the Ministry of Commerce, the largest investor in 2007 was Hong Kong, with US\$27.70 billion, followed by the British Virgin Islands, with US\$ 16.55 billion of investments. The other top 10 countries and regions were, in order, South Korea, Japan, Singapore, the US, Cayman Islands, Samoa, Taiwan and Mauritius. These 10 countries and regions accounted for nearly 88% of China's total actual foreign investment, and most of them are low tax jurisdictions or tax havens.⁷² According to some researchers, each year approximately 1/3 of the actual value of utilized foreign funds is domestic capital exported overseas and then fed back to China as 'false foreign capital'.⁷³ This increases the loss of state tax revenue.

⁷¹ Ministry of Commerce, *Statistics on Realized FDI Value by National Economic and Technological Development Zones in 2007* (2008)
<http://www.fdi.gov.cn/pub/FDI/wztj/kfqjt/2007kfqjt/t20080521_93066.htm> at 20 July 2008. The data was edited by the author.

⁷² Ministry of Commerce, *Statistics on FDI Utilization by Country/Region in 2007* (2008)
<http://www.fdi.gov.cn/pub/FDI/wztj/wstztj/lywzfgbdqjt/t20080121_89051.htm> at 9 March 2008. The data was edited by the author.

⁷³ *China Daily*, 'Investment outflows to tax havens' (2004) *China Economic Net*
<http://en.ce.cn/Business/Macro-economic/200406/22/t20040622_1127716.shtml> at 7 March 2008. See also *Shanghai Daily*, *Chinese invest more* (2006) *China Economic Net*
<http://en.ce.cn/Business/Macro-economic/200609/05/t20060905_8429892.shtml> at 11 March 2008.

F Tax chaos discouraged rational long term investment

With China opening its market to the world, it has been necessary to have flexible and diverse tax incentives to attract needed foreign investment. However, the implementation of these schemes has been chaotic. Some tax incentives are structured according to categories of taxes, others by industries, investment forms, preferred projects or geographic regions. Local preferential policies also have different tax levels applying in SEZs, coastal port cities, old urban districts, new development areas and so on. Inevitably, this creates conflicts and overlap between various preferential benefit levels. Foreign investors find it difficult to understand these benefit levels and this causes confusion and inconvenience in the management of the tax preference system.

Preferential policies in China have been amended and adjusted many times to align them with evolving policy objectives. Further, many transition periods for preferential tax treatment were implemented. Because of the lack of coordination between short and long term goals, and between the revenue requirements and structural goals in China, the taxation system produced conflict and overlap. Tax incentive clauses were scattered through various tax laws, implementation rules, administrative rules and regulations as well as supplementary regulations made by legislative institutions and executive departments. This deficiency in systematization, stability and transparency was exacerbated by frequent adjustments in the rates of various taxes and incentives.

At the same time, local governments established various other development zones and open zones in their regions, and used tax preference as a means of competition. These reductions were often unprincipled and seriously damaged national economic interests. Further, these local government initiatives disrupted orderly economic development, and resulted in a poor framework of tax legislation and a lack of transparency. After China's accession to the WTO, a stable and orderly environment attracted more investors who were optimistic about China's future.

STAGE 3: UNIFIED TREATMENT OF DOMESTIC AND FOREIGN ENTERPRISES

To solve China's current problems with their enterprise income tax systems, it is necessary to unify domestic and foreign-funded enterprise tax policies. Unifying the two income tax laws will not only promote improvement in China's economic structure and the upgrading of its industries, but will help to foster a legal environment that supports fair competition.⁷⁴

China's economy remains in a state of rapid development. The annual average growth rate of GDP from 1979 to 2004 was 9.6%; the rate was at or above 10% for the 5 years

⁷⁴ Jin Renqing, above n 64.

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from 2003.⁷⁵ China now leads the world in foreign exchange reserves with US\$ 1,528.2 billion held by the end of 2007.⁷⁶ Business has boomed in recent years, and fiscal revenues have maintained a strong momentum. Under such circumstances, the conditions are ripe to learn from the rest of the world and to implement a unified tax regime.⁷⁷

The reform should aim to establish an income tax regime which highlights the 'four unifications', that is: i) unification of income tax law applicable to both domestic and foreign funded enterprises; ii) unification of enterprise income tax rates; iii) unification of criteria and methods for tax deduction; and iv) unification of preferential income tax policies.⁷⁸ Such unifications would introduce a new preferential tax system with industry based incentives as the mainstay, and regionally based policies to supplement them. The Law 2007 which implements these changes took effect from 1 January 1 2008, and provides for a fundamental change in China's tax incentives policies. The aim of Law 2007 is to shape and direct the future development of the country.

A Preferential rates for small and low-profit companies and high/new tech enterprises

Law 2007 establishes a standardised tax rate of 25% of taxable income which applies to both domestic and foreign-funded enterprises. A lower tax rate of 20% is available for qualified small and low-profit enterprises, and 15% for qualified State-encouraged high/new technological enterprises without geographical limitation.⁷⁹ Further, a new concession for integrated circuit (hereafter referred to as IC) enterprises has been introduced.⁸⁰

⁷⁵ The growth rate of GDP was 10.0% in 2003, 10.1% in 2004, 10.4% in 2005, 11.1% in 2006 and 11.4% in 2007, when it reached CNY 24661.9 billion.

⁷⁶ National Bureau of Statistics of China, *Statistical Communiqué of the People's Republic of China on the 2007* (2008) <http://www.stats.gov.cn/was40/gjtj_en_detail.jsp?channelid=1175&record=92> at 25 March 2008.

⁷⁷ Jin Renqing, above n 64.

⁷⁸ Ibid.

⁷⁹ Law 2007 article 4, article 28.

⁸⁰ *CaiZhengbu, Guojia Shuiwu Zongju Guanyu Qiye Suodeshui Guogan Youhui Zhengce de Tongzhi* (Cai Shui [2008] No 1) [trans: *Circular of the Ministry of Finance and the State Administration of Taxation Concerning the Preferential Policies of Enterprise Income Tax*] (China).

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1 20% on qualified small and low-profit enterprises

For industrial enterprises, the concessionary 20% rate will only apply where taxable income is CNY 300,000 or less, the number of employees is 100 or less and total assets are CNY 30 million or less. For non-industrial enterprises, the relevant ceilings are taxable income of CNY 300,000, 80 employees, and total assets of CNY 10 million. In addition, the relevant enterprise must be in 'non-restricted and non-prohibited sectors'.⁸¹ The lower rate on small and low-profit enterprises will encourage them to become competitive with other enterprises in the new market economy.

2 15% on qualified high/new technological enterprises

As the principal remaining incentive, the criteria defining 'high/new technological enterprises' which qualify for the 15% tax rate are:⁸²

- Holding independent ownership of 'core IP rights';

Core IP rights refer to certain IP that is registered by a Chinese enterprise (excluding Hong Kong, Macau and Taiwan). This IP must have been obtained by self-development, transfer, gift, acquisition or other methods within the previous three years. Such IP also includes that obtained through exclusive licensing rights for periods in excess of five years. The relevant IP must support the key techniques of the enterprise's main products or services.⁸³ According to recent regulations, a specific requirement that the exclusive license rights must be held by the high/new technological enterprises and must be worldwide rights and not merely the right to exploit the relevant IP in China.⁸⁴ This onerous requirement may inadvertently cause many FIEs to fail to qualify for high/new technological enterprises' status because few parent companies of FIEs will wish to grant an exclusive worldwide license to their Chinese subsidiaries.⁸⁵

⁸¹ Rules 2007 article 92.

⁸² See, eg, Rules 2007 article 93.

⁸³ s 1 of Article 10, *Gaoxin Jishu Qiye Rending Guanli Banfa* (Guo Ke Fa Huo [2008] No 172) [trans: *Provisions for Recognition of High/New Technology Enterprises*](China).

⁸⁴ s 1 of Article 5, *Gaoxin Jishu Qiye Rending Guanli Gongzuo Zhiyin* (Guo Ke Fa Huo [2008] No 362) [trans: *Guidance on Recognition of High/New Technology Enterprises*]

⁸⁵ Deloitte, *PRC Tax—Research and Development (“R&D”) Tax Services —Analysis of Guidance on Recognition of High-New Technology Enterprises* (NTC Tax Analysis Issue P26/2008) (2008) <http://www.deloitte.com/dtt/cda/doc/content/cn_tax_tap262008eng_280708.pdf> at 28 August 2008.

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- The product/service is included in the State Encouraged High and New Technology Catalogue. (This catalogue is to be released by the State Council and the Science, Tax and Finance bureaus);⁸⁶
- R&D expenditure exceeds a minimum required percentage of annual sales revenue;

The ratio of qualifying R&D expenditures to sales revenue for the enterprise must meet relevant levels for the most recent three financial years based on the following criteria:

- A minimum 6% where the enterprise's revenue is less than RMB 50 million in the most recent financial year;
- A minimum 4% where the enterprise's revenue is from RMB 50 million to RMB 200 million in the most recent financial year; or
- A minimum 3% where the enterprise's revenue is more than RMB 200 million in the most recent financial year.⁸⁷
- Income from high-tech product sales or services exceeds the required percentage of total revenue;
- The ratio of the revenue generated from high-tech products and services must be more than 60% of total revenue;⁸⁸
- The number of R&D personnel exceeds the required percentage of all employees.

The recent regulations stipulate that over 30% of the total employees of the enterprise must be technical personnel holding college diplomas or higher degrees. Further, R&D personnel who are included in this highly educated technical personnel base must represent over 10% of the total workforce.⁸⁹ And, the enterprise must satisfy any other requirements.

For example, the enterprise must continuously conduct R&D activities concerning science and technology (excluding humanities and social sciences) to acquire new knowledge, make new and original uses of knowledge, or substantially improve existing technology, products or services. Further, the ratio of qualifying R&D costs for activities conducted physically within China must be at least 60% of total

⁸⁶ See also *Appendix—State-Encouraged High Technology Areas* in Guo Ke Fa Huo [2008] No 172.

⁸⁷ Section 4 of Article 10, Guo Ke Fa Huo [2008] No 172.

⁸⁸ Article 10(5), Guo Ke Fa Huo [2008] No 172.

⁸⁹ Article 10(3), Guo Ke Fa Huo [2008] No 172.

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qualifying R&D costs for the past three financial years, or for the actual years of operation, if less.⁹⁰

The new Law 2007 provides that the 15% rate will be applicable to enterprises qualifying as 'new and high/tech', irrespective of their locations. This may expand the applicability of the reduced tax rates from hi-tech enterprises in national high-tech development zones to such enterprises located throughout the country.

However, companies holding 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 qualification. The exception is so that they can enjoy other tax incentives stipulated in Law 2007 or other transitional benefits.⁹¹

15% on qualified integrated circuit enterprises

In order to be consistent with the innovation/high-tech goals of the government generally and its long-term 15-year innovation focused plan, the State Council and its branch departments have issued new circulars which provide a comprehensive approach to encourage IC production in China.

A tax rate of 15% can be enjoyed by IC production companies when total investment exceeds CNY 8 billion, or where IC products have a width of less than 0.25 μ m.⁹²

NEW TAX INCENTIVE POLICY

1 Reduction and Exemption Targets

Tax reduction and exemption treatments are targeted primarily towards:

- Major State-supported public infrastructure facility projects⁹³ and qualified environment protection projects, water or energy conservative projects,⁹⁴ from

⁹⁰ Article 10(4), Guo Ke Fa Huo [2008] No 172.

⁹¹ *Guojia Shuiwu Zongju Guanyu Qiye Suodeshui Yujiao Wenti de Tongzhi* (Guo Shui Fa [2008] No 17) [trans: *Circular of the State Administration of Taxation on Several Issues Related to the Enterprise Income Taxes*](China). See also *Guowuyuan Guanyu Jingji Tequ he Shanghai Pudong Xinqu Xin Sheli Gaoxin Jishu Qiye Shixing Guoduxing Shuishou Youhui de Tongzhi* (Guofa [2007] No 40) [trans: *Notification of the State Council on Transition Incentives for High/new Technology Enterprises Established in SEZs and Pudong New District of Shanghai*] (China).

⁹² Article 1(8), Cai Shui [2008] No 1.

⁹³ Law 2007 article 27(2), Rules 2007 article 87, the covered projects refer to projects as listed in the *Catalogue of Enterprise Income Tax Incentives for Public Infrastructure Facility Projects*,

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the first revenue producing year, a three-year exemption is granted, followed by a three-year 50% reduction in the normal 25% tax rate.⁹⁵

- Numerous activities in the agricultural, forestry, animal husbandry and fishery industries are subject to the full exemption. Some other specified activities in these fields are allowed a 50% reduction in the normal 25% tax rate.⁹⁶
- Income earned from qualifying technology transfer are subject to tax exemptions and deductions.⁹⁷ Dividend income and other distributions with respect to equity interests paid between qualifying resident enterprises are also tax-exempt.⁹⁸
- With the objective of encouraging development of software production and integrated circuit production industries in China, more reductions and exemptions can be enjoyed by such companies, which include: a two-year tax holiday followed by a three-year 50% reduction from the first profit-making year for newly established approved software production companies or approved IC production companies when ICs have a width of less than 0.8 μ m;⁹⁹ a five-year tax holiday followed by a five-year 50% reduction for integrated circuit production companies with a 15-year or more operational 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 μ m.¹⁰⁰

such as pier and dock projects, airports, railroads, roads, urban public transportation, electricity projects, water resources utilization projects, etc.

⁹⁴ Law 2007 article 27(3), Rules 2007 article 88, the covered projects include public wastewater treatment, public refuse treatment, comprehensive exploitation and utilization of bio-gas, upgrade of energy-saving/pollution-discharge-reduction technologies, seawater desalination projects, etc.

⁹⁵ Rules 2007 articles 87 and 88. See also Zhang Sihai, Li Hong and Zou Guojin, 'Xiangjie Qiye Suodeshui Fa Shishi Tiaoli Xinyi ji Liangdian', *Zhongguo Shuiwu Bao* (Beijing, China), 17 December 2007, 1, 2 [trans: 'New ideas in Implementation Rules of Enterprise Income Tax Law' in *China Taxation News*]. The beginning of the tax holiday shifted from the first profit-making year to the first revenue producing year in order to deter FIEs from using various tactics to postpone profit-making to leave the low rate to future years.

⁹⁶ Law 2007 article 27(1), Rules 2007 article 86.

⁹⁷ Law 2007 article 27(4), Rules 2007 article 90. Qualifying transfers of technology by resident enterprises shall be subject to tax exemption with a cap of RMB 5 million for income earned in a taxable year from the transfer of ownership of technologies, and any excess shall be subject to a 50% reduction in the normal 25% tax rate.

⁹⁸ Law 2007 article 26(2), Rules 2007 article 83.

⁹⁹ Article 1(2) and Article 1(9), Cai Shui [2008] No 1.

¹⁰⁰ Article 1(8), Cai Shui [2008] No 1.

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- In order to encourage the growth of Chinese security investment funds, income earned by security investment funds and their investors in securities markets can be temporarily exempted from enterprise income tax.¹⁰¹

2 Industry specific in indirect tax concessions

The Law 2007 introduced more indirect tax concessions to encourage certain industry, infrastructure, environmental protection, etc, including the following:

- Special deductions are allowed for research and development expenses incurred by an enterprise during the development of new technology, new products and new techniques,¹⁰² and for salaries paid to disabled persons and other persons in employment to whom the State has encouraged enterprises to offer assistance;¹⁰³
- Tax deductions are available to Venture Capital enterprises in industries where the State has placed heavy emphasis on promoting their development and growth;¹⁰⁴
- Short tax depreciation life or accelerated depreciation is allowed for particular types of fixed assets affected by advanced technology or constantly exposed to high vibration or high corrosion;¹⁰⁵
- Reduction allowances may be allowed for revenue earned from products manufactured with certain recycled or waste products or using energy saving technologies pursuant to State industry policies;¹⁰⁶

¹⁰¹ Article 2, Cai Shui [2008] No 1.

¹⁰² Law 2007 article 30, Rules 2007 article 95. Any qualifying R&D expenditure properly chargeable to the income statement will be allowed an additional 50% super deduction. For any such expenditure capitalized as intangible assets, 150% of the cost of the intangible asset will be the basis for amortization.

¹⁰³ Law 2007 article 30, Rules 2007 article 96. The super-deduction for salaries paid to disabled persons refers to a 100% super-deduction on the salaries expense in addition to the actual expense deduction.

¹⁰⁴ Law 2007 article 31, Rules 2007 article 97. Where a venture capital enterprise invests in the shareholdings of small or medium high/new technology enterprises for more than two years, 70% of the investment amount may be deducted from taxable income for the year when the two-year holding is completed. Unutilized deduction may be carried forward to the following tax years.

¹⁰⁵ Law 2007 article 32, Rules 2007 article 98.

¹⁰⁶ Law 2007 article 33, Rules 2007 article 99. Where enterprises utilize resources listed in the *Enterprise Income Tax Incentive Catalogue for Comprehensive Utilization of Resources* as main raw materials to manufacture non-State-restricted or non-prohibited products which meet

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- Investment tax credits are allowed on qualifying expenditures on plant and machinery used for environmental protection, energy and water conservation, and production safety.¹⁰⁷

Adoption of the cost sharing rules in Law 2007 is very beneficial from a tax perspective. These rules provide that cost sharing arrangements may cover the joint development of intangible assets and the provision of labour services. To the extent that a Chinese enterprise makes cost sharing cash payments to an overseas party, it is considered to be bearing its share of expenses and not paying a royalty or service fee. This means, for example, that because it is not characterized as a royalty, there will be no business tax or royalty withholding tax. Similarly, if payments are made under a service cost sharing agreement and the recipient foreign enterprise has performed some of the services in China, there should be neither business tax nor enterprise income tax payable since the foreign enterprise will have received no service fee income.¹⁰⁸

At the same time, some benefits would be abolished on 1 January 2008, the effective date of Law 2007. These include tax holidays and low tax rates on manufacturing FIEs, the extended reduction to export oriented FIEs and advanced technology enterprises, low rate on FIEs engaged in production or located in special areas, and refunds of taxes paid on profits that are reinvested.¹⁰⁹ These new changes represent a clear

relevant national and industry standards, 10% of the revenue derived from such product sales may be recognized as a deduction for enterprise income tax purposes.

¹⁰⁷ Law 2007 article 34, Rules 2007 article 100. Where enterprises purchase and actually use specialized equipment which aids in protecting the environment, conserving water or reducing energy usage, or enhancing production safety and which are listed in *Enterprise Income Tax Incentive Catalogue for Specialized Equipment in Environment Protection*, *Enterprise Income Tax Incentive Catalogue for Specialized Equipment in Water Conservation or Energy Usage Reduction*, or *Enterprise Income Tax Incentive Catalogue for Specialized Equipment in Production Safety*, 10% of the equipment's investment cost may be credited against the current year's income tax payable of the enterprise. If the credit is not fully utilized, the remaining balance may be carried forward to the following five tax years.

¹⁰⁸ Deloitte, *PRC Tax — Related party transactions: New law developments and related issues* (Issue M05/2007) (2007) <http://www.deloitte.com/dtt/cda/doc/content/m052007_Eng.pdf> at 11 March 2008.

¹⁰⁹ Article 1, Guojia Shuiwu Zongju Guanyu Waishang Touzi Qiye he Waiguo Qiye Yuanyou Shuishou Youhui Zhengce Quxiao hou Youguan Shixiang Chuli de Tongzhi (Guo Shui Fa [2008] No 23) [trans: *Circular of the State Administration of Taxation on Tax Issues Clarified for Certain Abolished Enterprise Income Tax Incentives*] (China).

See also Deloitte, *PRC Tax — The direction of Chinese tax incentives... and planning for such incentives* (Issue M03/2007) (2007) <http://www.deloitte.com/dtt/cda/doc/content/m032007_Eng.pdf> at 11 March 2008.

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departure from the wide-ranging benefits previously available for manufacturing generally and for specific locations. This indicates that the new trends in tax incentives are: a shift away from granting incentives only in special regions and to benefits available to the entire country; a shift away from a regional development orientation to an industry orientation; and a shift from an export oriented economy to a domestically driven economy.¹¹⁰

GRANDFATHER RULES FROM PREVIOUS PREFERENTIAL TAX TREATMENTS

Many existing enterprises have been granted tax holidays and tax reduction incentives.

The implementation of Law 2007 will have a significant impact on the tax burden of FIEs, especially those which enjoyed tax preferential policies based on Law 1991. In order to maintain trust in the integrity of the taxation system and maintain the continuity of income tax preferential policies, Law 2007 develops some transitional measures for old enterprises that enjoyed low tax rates or regular tax reduction and exemption treatment. FIEs that completed business registration procedures prior to the promulgation of Law 2007 may continue to enjoy the current tax preference policies under the transitional preferential measures.

These transition measures include:

1 Transition benefits for prior incentives

- Enterprises enjoying preferential treatment in the form of reduced enterprise income tax rates under previous tax laws and regulations, are allowed a gradual transition to the tax rates stipulated in Law 2007 over the five year period beginning from the effective date of the law.¹¹¹
- Enterprises currently enjoying preferential treatment in the form of enterprise income tax reductions or exemptions may continue to enjoy such treatment until the end of the preferential treatment period, but enterprises which have not yet become profitable and are therefore able to enjoy preferential treatment will have

¹¹⁰ Deloitte, 'PRC Tax— Implementation Rules— Breaking News' (Issue P20/2007) (2007) <http://www.deloitte.com/dtt/cda/doc/content/en_EIImplementationrules_071211.pdf> at 11 March 2008.

¹¹¹ Law 2007 article 57 s 1, and article 1, Guo Fa [2007] No 39. Enterprises which enjoyed the 15% enterprise income tax rate shall be subject to the 18% enterprise income tax rate in 2008, 20% in 2009, 22% in 2010, 24% in 2011 and 25% in 2012. The enterprises that enjoyed the tax rate of 24% in the past will be subject to the 25% tax rate as of 2008.

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the commencement of the preferential treatment period coincide with the year Law 2007 comes into effect.¹¹²

These transition benefits are limited to the 30 incentives listed in Guofa [2007] No.39 which issued on December 26, 2007.

2 Transition benefits for special zones

State-encouraged new technology and high technology enterprises located within legally established special zones for the promotion of foreign trade, economic and technological cooperation and other such zones as administered by the State Council will enjoy transitional benefits.¹¹³ According to the Circular of the State Council, for a high/tech enterprise under state support system in a SEZ or in Pudong New District of Shanghai that was registered on or after 1 January 2008, the incomes acquired by it in these zones shall be exempt from enterprise income tax for the first two years after the tax year to which the first revenue coming from production or operation is payable, and shall be levied at half of the statutory tax rate of 25% for the third to the fifth years.¹¹⁴

In order to support the Western Development Program, certain preferential policies for the Western Development Program with regard to enterprise income tax (mentioned in the *Notification on the Preferential Policies for Western Development Program with regard to Enterprise Income Tax* (Cai Shui [2001] No. 202) jointly promulgated by the Ministry of Finance, State Administration of Taxation and General Administration of Customs) will be maintained and continued.¹¹⁵

3 Transition benefits on refunds for reinvestment

An important feature of the tax incentives system operating prior to the reform was the ability of foreign investors to receive refunds of taxes paid by companies which reinvested their profits either in the companies paying the dividends or in other companies. This kind of incentive was eliminated in Law 2007 but foreign investors who 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 will receive that refund in accordance with the old tax law.¹¹⁶

¹¹² Law 2007 article 57 s 1, and article 1, Guo Fa [2007] No 39.

¹¹³ Law 2007 article 57.

¹¹⁴ Article 2, Guo Fa [2007] No 40.

¹¹⁵ Article 2, Guo Fa [2007] No 39.

¹¹⁶ Article 1, Guo Shui Fa [2008] No 23.

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The only retained refunds for reinvestment is any reinvestment in an IC production or assembly company for the three calendar years from 2008 through 2010. A refund of 40% of the tax paid by an IC production or assembly company on any profit distributions (i.e. dividends) paid to an investor in that company who then reinvests this 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 required for both alternatives. Moreover, a refund of 80% of the tax paid by any Chinese company on any profit distributions (i.e. dividends) paid to an investor in that company who reinvests this after-tax share of profits as capital investment into a newly established company in western region of China. This applies only to investment in companies that will operate for five years or more and that are engaged in IC production or assembly, or companies that qualify as software production companies.¹¹⁷

4 Transition benefits on withholding tax exemptions

Law 2007 provides a 10% withholding tax on dividends. However, this tax will not be imposed on a dividends paid by an FIE from pre-2008 earnings to non-resident shareholders.¹¹⁸

Transitional benefits are available on certain royalties and interest, which were exempted from withholding tax under the old tax law. Any applicable tax exemption will continue to apply during the contract period so 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.¹¹⁹

OTHER REGULATIONS CHANGING BENEFITS OF FIES

Law 2007 unifies the policy for deduction of costs and other expenditures. This may disadvantage FIEs compared with the deductions available in the past, and may result in an increase in the taxable profit of the FIEs. For example, expenditure incurred in connection with approved charitable donations may be deducted when computing taxable income if it does not exceed 12% of the year's total profits.¹²⁰ Reasonable employee salaries and remuneration incurred by an enterprise are deductible.¹²¹ 60% of the entertainment expenses incurred by an enterprise in relation to manufacturing

¹¹⁷ Article 1(10), Cai Shui [2008] No 1.

¹¹⁸ Article 4, Cai Shui [2008] No 1.

¹¹⁹ Article 2, Guo Shui Fa [2008] No 23.

¹²⁰ Law 2007 article 9.

¹²¹ Rules 2007 article 34.

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or business operations may be deducted, but the total entertainment expenses may not exceed 5% of sales (operating) revenue for the relevant period.¹²² Up to 15% of sales (operating) revenue may also be deducted for advertising and marketing expenses incurred but those expenses must satisfy relevant requirements unless government authorities of the State Council in charge of finance and taxation stipulate otherwise; however the portion above the ceiling can be carried forward to the following tax years for deduction.¹²³

In accordance with international practice, the terms ‘resident enterprise’ and ‘non-resident enterprise’ are used in the Law 2007.¹²⁴ The introduction of an ‘effective management’ concept of corporate residence in Law 2007 will have a significant impact on the Chinese income tax liability of enterprises incorporated outside China (Foreign Enterprises). A Foreign Enterprise that is managed or controlled from China will be a Chinese tax resident and, thus, subject to Chinese enterprise income tax on its worldwide income in the same manner as a domestic enterprise or FIE. Non-resident Foreign enterprises will be taxed only on certain China-sourced income, and income that is effectively connected to an establishment in China.¹²⁵ The move towards taxing enterprises according to their residency status is a significant change to Chinese taxing principles. Some Foreign Enterprises may be considered to have their effective management institutions based in China and may be caught under this new provision. These include ‘red chip’ enterprises, typically listed in Hong Kong but operating in China by controlling Chinese shareholders and ‘tax haven’ enterprises, especially those used for ‘round-tripping’ investments inside China and for overseas listing purposes.¹²⁶ In practice, such companies operate from inside China, and this new policy will result in Chinese taxes being levied on their worldwide income.

SUMMARY — CHARACTERISTICS OF THE NEW TAX INCENTIVES

These changes in tax incentives illustrate new trends in China. First, the new preferential tax system grants industry-based incentives as the mainstay, with regionally based schemes as a supplement. There will be a clear shift from the tax holidays and tax rate reductions for manufacturing companies, both generally and in certain specific locations, and a more focused approach on encouraged industries,

¹²² Ibid article 43.

¹²³ Ibid article 44.

¹²⁴ Law 2007 article 2.

¹²⁵ Rules 2007 article 3.

¹²⁶ Deloitte, ‘PRC Tax—The New Residence Concept — Who should be concerned and, if you are, what should you do?’ (Issue M06/2007) (2007)
<http://www.deloitte.com/dtt/cda/doc/content/m062007_Eng.pdf> at 13 March 2008.

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social issues, and regionally based preferential treatment.¹²⁷ To adjust the industrial structure and regulate the economy, reduced income tax benefits will be given to key industries and projects whose development is supported and encouraged by the State. Industries that will benefit include energy conservation, water-saving and those implementing a comprehensive utilization of resources, high-tech industries, the construction of infrastructure projects, and coal mine safety equipment. All of these are considered to be advantageous to the promotion and upgrading of China's industrial structure. Regional tax concessions will remain as supplementary measures, which is a significant shift away from SEZs, economic and technological development zones, and other area. Concessions which formed the basis of the previous preference policies to middle and western regions, national minorities areas etc, will continue under the new law.

Second, the emphasis in tax incentives will shift from direct to indirect measures. Future preferential policies will focus on carry-over losses, investment credits, accelerated depreciation, special deductions for R&D expenses, cost sharing arrangements and other indirect means, instead of fixed tax exemptions or lower rates.

Third, low level tax reductions will be terminated. Tax concessions will be aimed at developing high/tech industries and raising technological content, both of which are critical to China's future success. Preferential policies to new enterprises are cancelled while other incentives are introduced to encourage specific industries and certain venture capital enterprises.

IMPACT OF THE NEW LAW

A Impact on FIEs and foreign investors

The nominal income tax rate dropped to 25% from 33%. But as many FIEs have enjoyed low effective tax rates due to the broad incentive system (eg 24%, 15%, and even 0%), the implementation of the Law 2007 will increase the tax burdens of FIEs as a whole, especially on manufacturing enterprises.

The applicability of reduced tax rates and tax relief for high/tech enterprises will be extended nationwide, and some FIEs will benefit from the expanded concession. In fact, in order to meet their business needs, more and more FIEs have established independent R&D centres in China. These include Microsoft, GE, Motorola, Intel, GM,

¹²⁷ Deloitte, 'PRC Tax—The Direction of Chinese Tax Incentives and Planning for Such Incentives' (Issue M03/2007) (2007)
<http://www.deloitte.com/dtt/cda/doc/content/m032007_Eng.pdf> at 11 March 2008.

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Honda, Siemens, Nortel, and Volkswagen. These R&D centres are engaged in technological activities geared toward transforming products for local market consumers and are established in regions with colleges and universities to take advantage of China's wealth of scientific research and technological talent.¹²⁸ Such enterprises may enjoy the new tax concessions under Law 2007, even if they are not located in High-Technology Industrial Development Zones.

Some foreign-funded enterprises will enjoy the concessionary tax rate that is available to small low profit enterprises. As Mr Jin Renqing, the Minister for Finance, stated during a press conference, the majority of enterprises in China (including approximately 60% of all enterprises formed with Hong Kong, Macau or Taiwan capital) would fall into this category and the tax rate imposed on them has only been raised by 5%.¹²⁹

A considerable proportion of FIEs will also enjoy transitional measures. The implementation of the new tax law will not have a tremendous impact on the current taxation cost of FIEs. With the implementation of the new law, the tax rate for FIEs engaging in general service, financial, telecommunication and real estate enterprises will be reduced from 33% to 25%. This will facilitate their development and help to promote and develop of China's tertiary industries.

Meanwhile, with the termination of most geography-oriented tax incentives and preferentially low tax rates, FIEs engaging in certain traditional industries, such as manufacturing low-end products, labour-intensive production, and export oriented FIEs in general industries will enjoy only limited incentives for activities such as qualified R&D activities, capital investment, etc. This will pressure them to upgrade their technology and labour productivity. The key drivers for the FIEs' investment selections will shift from tax incentives, to operating factors such as proximity to natural resources and local markets and human resources.¹³⁰

B Impact on industries

Current foreign investment in China is involved in a wide variety of industries with different characteristics. The impact of the preferential tax policy adjustments on them is also different. In contrast to heavy industry, light industries, particularly those using agricultural products as raw materials, will be greatly affected by the tax incentives. This includes business such as food and beverage manufacturing, textile,

¹²⁸ Long Guoqiang, 'China's Policies on FDI: Review and Evaluation' (2005) *Does Foreign Direct Investment Promote Development?* 330, 331.

¹²⁹ Jin Renqing, above n 64.

¹³⁰ Deloitte, above n 111.

apparel and fibre products industries, timber processing, furniture manufacturing and other areas with low technological content, small-scale investment and simple production facilities. Typically in these businesses, lower production conditions and simple technical workers are required. With the reduction of preferential tax policies, the profit of light industry FIEs will decline. Their operating situation will possibly be worse, and the global positioning of such industries may shift to other developing countries as the inflow of foreign capital to these industries in China will decrease enormously.

Heavy industries, especially those enterprises with high technological content and more complex production facilities - such as petroleum processing, chemical raw material and product manufacturing industries and machinery and equipment manufacturing - require high level facilities and technical proficiency in the labour force. These industries require a better market environment and infrastructure, and so are not greatly influenced by preferential tax policies. Although foreign profits will be reduced with the tax preference reduction in the new law, this will have little effect on the inflow of foreign capital. Therefore, inflow of foreign capital to heavy industries will not be greatly reduced. Because of the need for heavy industries to be centred in specific locations and their need for heat, gas and raw materials for production (with the exception of the manufacturing industry), heavy industries will not shift to other countries as a result of the adjustments to their tax incentives.¹³¹

More importantly, the evolution of China's tax incentives represents a clear shift from an export orientation to a domestically-driven economy. It also shifts the focus of benefits for more traditional industries, such as manufacturing, to the budding technology and hi-tech sector. For example, existing incentives will be expanded for high/tech enterprises and R&D activities through a low 15% tax rate available to certain new and high-technology enterprises. This is independent from where the enterprise is located, and is implemented through reaffirmation of the super deduction for qualifying R&D expenses.

Other incentives apply to encouraged industries; certain venture capital enterprises; certain major infrastructure, environmental and agricultural projects; encouraged industries in the western region; and certain labour and welfare services.¹³²

¹³¹ Yuan Xinli, *Qiyе Suodeshui Youhui Zhengce Tiaozheng dui Waizi Liuru de Yingxiang* [Adjustment of enterprises income tax incentives and impact on FID inflows] (2008) Enterprises Service Centre
<http://www.chinataiwan.org/tsfwzx/zxzx/200802/t20080213_585515.html> 4 March 2008.

¹³² Deloitte, 'PRC, Tax—Enactment—Breaking News' [16 March 2007]. Available at www.deloitte.com.cn.

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In 2006, the Chinese government nominated ‘innovation and technological advancement’ as one of China’s principal long-term national strategies. The government realised that China could not continue to expand its economy merely by producing products on a low cost basis than the rest of the world. China had to move up the value-added chain, which can be accomplished only by moving to higher value products and higher value technology.¹³³ Tax policies can hasten and support this initiative through stimulation of the high/tech, infrastructure, agriculture, and other industries through promotion of industrial upgrading and technical progress. China’s aim is to optimize the structure of the national economy as required by the industrial policy of the State.¹³⁴

C Impact on the total amount of foreign fund

With the adjustment of preferential policies, the degree of influence on the total amount of foreign direct investment depends primarily on the scale of foreign-funded enterprises.

Generally speaking, enterprise decision-making is more prudent in large-scale investment and always needs to consider the comprehensive investment environment of the region. The relevant factors include the level of economic development of the area, the availability of a high-quality labour force, existing infrastructure and industrial clustering. Tax concessions are only one factor in this equation. Therefore, the adjustment of tax incentives has less effect on a multinational corporation’s decision making in large-scale investment however small-scale firms are often more flexible and choose to leave when rising operating costs lead to lower profits in any particular region.

Most investments from Hong Kong, Macao and Taiwan are focused on small-scale and labour-intensive enterprises engaged in simple production and processing industries. These are driven mainly by the availability of cheap labour to manufacture products for export to Hong Kong, Taiwan or to third countries. This kind of enterprise mostly attracts export-oriented investment, and is more sensitive to the cost of operation, including the tax burden. When operating costs increase because of tax rate variations and the elimination of preferential policies, such investments are likely to be withdrawn or transferred to peripheral low-tax countries or regions. Generally, small-scale firms have higher mobility when compared to the large scale counterparts.¹³⁵

¹³³ Deloitte, above n 128.

¹³⁴ Jin Renqing, above n 64.

¹³⁵ Yuan Xinli, above n 132.

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China's current foreign direct investment environment, large-scale investment from Europe, America, Japan and other developed countries continues to increase. With headquarters of more and more multinational corporations locating in China, large-scale investment will be constantly reinforced. This type of high grade investment pays more attention to economic and political stability, and the sufficient supply of skilled labour and efficient management systems than it does to short term profits. After massive investment in the initial period, such large-scale investors will not withdraw or stop later investment because of relatively minor reductions in tax enhancement or preferential taxation policies.

In 159 countries or regions around the world in which an enterprise income tax is applied, the average tax rate is 28.6 %.¹³⁶ The rate in China's 18 neighbouring countries or regions is 26.7 %.¹³⁷ The 25 % rate set in the Law 2007 is relatively low by world standards and will be conducive to enhancing enterprise competitiveness and attracting foreign investment. Meanwhile, international experience has shown that political stability, sound economic development, large markets, rich human resources and constantly improving legal environment and government services are the main factors for attracting foreign investment. As mentioned above, tax preferences are but one factor.¹³⁸ Therefore, the new Tax Law is not likely to have a great impact on foreign investment.

From January to September 2008, 20,801 new FIEs were established in China. This was down 26.25% from the same period in 2007, but the amount of foreign capital actually used was US \$76.441 billion, an increase of 36.52%.¹³⁹ This demonstrates that as long as China progressively improves its investment environment and long terms attitude to attracting foreign capital, the adjustment of tax policies will not lead to a large withdrawal of foreign capital.

CONCLUSION

Throughout different historical stages, the Chinese government has consciously used tax incentives as an instrument to achieve certain national economic, social and environmental objectives. It was believed that the incentives would promote foreign investment in general, as well as regional and industry-specific investment. These

¹³⁶ Jin Renqing, above n 64.

¹³⁷ Ibid.

¹³⁸ Ibid.

¹³⁹ Ministry of Commerce, *Statistics about Utilization of Foreign Investment in China from Jan to Sep. 2008* (2008)
<http://www.fdi.gov.cn/pub/FDI_EN/Statistics/FDIStatistics/StatisticsofForeignInvestment/t20081024_98496.htm> at 25 October 2008.

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incentives played an important role in the early days of China's transition to a market economy.

Economic analysis suggests that the impact of such incentives on investment is modest, especially compared to the often hidden costs to the government budget. At the same time, the business advisory committee to the OECD advises that, if a country grants tax incentives, these should be available to all investors, be non-discriminatory, have a long term orientation, and be proportional to the goals.¹⁴⁰ The broad and far-reaching reform to tax rates and incentives in Law 2007, together with the introduction of transitional measures, will eliminate the variations that were evident over the previous 26 years. China will introduce a level playing field for domestic enterprises and FIEs alike, thereby altering the tax landscape almost beyond recognition. Law 2007 shows the progress of legislation in China from imbalance to fair competition as the national economy develops from closed to open.

The focus of incentives has shifted from special regions to the entire country, from a regional development orientation to an industry orientation, from an export oriented to a domestically-driven economy. This focus will facilitate overall planning for coordinated economic, social and regional development, promote improvement in China's economic structure, and the upgrade its industries. It appears that China is on its way to achieving long-awaited sustainable development of their national economy.¹⁴¹

¹⁴⁰ OECD, *The OECD Welcomes Policy Advances at China's 2007 National People's Congress Session* (2007) <<http://www.oecd.org/dataoecd/20/12/38309228.pdf>> at 20 March 2008.

¹⁴¹ The author acknowledges and thanks Andrew Antonopoulos for his editorial assistance on this article.