

PRC NEW ENTERPRISE INCOME TAX REGIME -- SIGNIFICANT IMPACT ON FOREIGN INVESTORS CONDUCTING MERGERS AND ACQUISITIONS IN CHINA

By Lawrence Guo, Partner of Broad & Bright

The new PRC Enterprise Income Tax Law (“**EIT**”) which went into effect on 1 January 2008 brings about significant income tax changes for foreign corporations and their operating subsidiaries in China. This note reviews the key changes in the new EIT legal regime that a foreign acquirer needs to be aware of when conducting mergers and acquisitions activities in China.

To recap the background, the new EIT was promulgated by the PRC National People’s Congress on 16 March 2007. The Detailed Implementation Regulations (“**DIR**”) for implementation of the EIT were approved by the PRC State Council on 6 December 2007. In line with the PRC’s normal legislation practices, in the past months the PRC Ministry of Finance (**MOF**), State Administration of Taxation (**SAT**) and a few other ministries have issued a number of detailed rules and circulars that clarify and flesh out the new EIT legal regime.

A. A UNIFORM CORPORATE INCOME TAX RATE OF 25% FOR ALL CORPORATIONS IN CHINA

After 1 January 2008, a foreign acquirer should assume that a PRC corporate target or a new PRC corporate vehicle established to hold acquired assets shall be subject to a uniform corporate income tax rate of 25% post acquisition, unless the target may enjoy one or more of the tax benefits available.

In general, the new 25% EIT shall apply equally among PRC pure-domestic and foreign-invested enterprises (“**FIE**”). This is very different from the old EIT regime under which the normal income tax rate for FIEs was 33%, but there were wide-spreading tax holidays and reductions offered to FIEs based on geographical and industrial differences, which as a matter of fact significantly reduced the income tax burden of FIEs.

FIEs established prior to the promulgation of EIT (i.e., 16 March 2007) have been offered a transitional policy and a grandfathering of their pre-existing preferential tax treatment:

- A pre-existing FIE granted a tax holiday (e.g., exemption in first 2 years and half reduction in subsequent 3 years from the first profit-making year) prior to 1 January 2008 may continue enjoying the tax holiday until the expiry of the tax holiday period. However, if the tax holiday has not started as of 1 January 2008 because the company has not made its first profit for triggering the tax holiday clock, the tax break shall count from the year of 2008.
- A pre-existing FIE approved to follow a lower income rate prior to 1 January 2008 shall follow a phaseout period up to five years (i.e., 2008 - 2012). If the previous EIT rate was 15%, the transitional creeping rates would be: 18% (2008), 20% (2009), 22% (2010), 24% (2011) and 25% (2012). If the previous EIT rate was 24%, the new rate (25%) will be immediately applicable beginning in 2008.

Based on our past experience, if a foreign investor acquires the equity of an existing FIE, the grandfathering benefit of the target should not be forfeited just because of the equity acquisition.

B. 15% EIT RATE FOR A “HIGH AND NEW TECHNOLOGY ENTERPRISE” (“HNTE”)

If a PRC acquisition target can be verified by PRC authorities as a “high and new technology enterprise” (“HNTE”), the target shall enjoy the 15% EIT rate. This appears to be the most attractive tax benefit available under the new EIT.

PRC Ministry of Science and Technology (“MOST”), MOF and SAT issued *The Measures on Assessment and Administration of HNTEs* (“HNTE Measures”) and *the Catalogue of High and New Technological Domains Especially Supported by the State* (“High-tech Catalogue”) on 14 April 2008. In addition, a draft of *the Working Guidelines for Verification and Administration of HNTEs* (“HNTE Guidelines”) was simultaneously released for public comments by the same authorities, and the finalised HNTE Guideline is expected to be out very soon. These rules clarify the governmental authorities, requirements, procedures relating to assessment of HNTEs.

Substantial requirements: The substantial requirements for a HNTE as set out in the HNTE Rules include the following:

- a) A HNTE should hold IP rights of the core technology for its primary products (or services), obtained within the past 3 years by way of self R&D, transfer, purchase, or an exclusive license of at least a 5-year term, or other means;
- b) Its primary products (or services) shall be included in the High-tech Catalogue;
- c) Personnel engaged in “scientific and technical activities” with at least two-year college education shall account for at least 30% of the total employees, among which “R&D personnel” shall account for at least 10% of the total employees of the company;
- d) A HNTE should continually carry out “R&D activities”. Its R&D expenditure should reach a prescribed percentage of total revenue within past 3 years: 3% if revenue in recent past year was more than RMB200m, 4% if between RMB50m to RMB200m, and 6% if less than RMB50m. R&D expenditure incurred in China should be not lower than 60%;
- e) Revenue from high and new-tech products (or services) shall be more than 60% of the total revenue of the company for the given year; and
- f) A HNTE should meet the rating requirements (prescribed in the HNTE Guidelines) in terms of R&D organizing and management capabilities, capability of converting R&D results to products, number of self-held IP rights, and growth of sales and total assets.

The to-be-issued HNTE Guidelines will set forth detailed provisions on such terms as self-owned core IP rights, R&D personnel, R&D activities, R&D expenditure, revenue from high and new-tech products (or services), etc.

Authority in charge: A new “assessment administration authority” comprised of officials from provincial-level departments in charge of science and technology, finance and taxation shall be established. A working office shall also be set up within the provincial-level science and technology department. These authorities will accept HNTE applications and grant HNTE status to approved applicants.

A HNTE qualification shall be valid for 3 years. A HNTE must apply for a re-assessment within 3 months with the same assessment authority before the expiry of the HNTE qualification.

It seems that some foreign-invested manufacturing or service enterprises should be able to meet the new HNTE qualification. Therefore, a foreign acquirer is advised to plan carefully whether a PRC acquisition target will be able to meet the HNTE qualification and accordingly to enjoy the 15% EIT rate.

C. OTHER TAX BENEFITS UNDER THE NEW EIT

(1) Transitional tax holidays for HNTEs incorporated in “special foreign cooperation regions”

If a company is incorporated after 1 January 2008 within one of the “special foreign cooperation regions” (which includes: Shenzhen, Zhuhai, Shantou, Xiamen, Hainan Special Economic Zone and Shanghai Pudong New Area) and is duly verified as a HNTE, such company may, starting from the fiscal year in which the first operation revenue is realized, be exempt from EIT for the first two years, and enjoy the rate of 12.5% in the subsequent three years. Moreover, it should be noted that the EIT and related regulations do not set a phaseout deadline. A foreign investor may make use of such transitional tax holidays by finding particular targets in the above-mentioned regions, provided this also makes good commercial sense.

(2) Special tax benefits offered to enterprises in western regions of PRC

A FIE established in one of 13 specified western regions (i.e., Chongqing, Sichuan, Guizhou, Yunnan, Tibet, Shaanxi, Gansu, Ningxia, Qinghai, Xinjiang and Xinjiang Production and Construction Corps, Inner Mongolia, Guangxi), whose primary business falls under the “Encourage” category, shall pay a 15% EIT prior to the end of 2010. Equipment imported by such a FIE within its total investment amount for use in its own manufacturing can be exempted from import duty and VAT.

(3) Tax holidays for investment projects in infrastructure construction

Infrastructure investment projects that are “especially supported by the State” may be exempted from EIT for first three years starting from the year when the first revenue is realised, and be subject to a 12.5% EIT rate in subsequent three years. Infrastructure projects eligible for this tax holiday include investments in ports and

wharfs, airports, railways, highways, urban public transportation, power, water conservancy, etc., and shall be detailed in a special infrastructure project catalogue to be issued by relevant authorities.

(4) Tax holidays for investment projects in environmental treatment, energy-saving and water-saving sectors

Types of project eligible for this tax benefit include public wastewater treatment, public sewage treatment, comprehensive development and usage of methane, technical innovation for energy-saving and emission reduction, seawater desalination. Detailed requirements and scope for eligible projects shall be further issued by relevant ministries. The tax holidays are the same as those granted for eligible infrastructure investment projects outlined in the preceding subsection.

(5) Special tax deductions for equity investments in eligible start-up enterprises

If a venture capital investor makes an equity investment in a non-listed small or mid-size high-tech enterprise for more than two years, the investor may make a special tax deduction equivalent to 70% of its equity investment.

(6) EIT tax benefit in the software and integrated circuit industries

Enterprises that engage in software or integrated circuit businesses are granted some preferential tax benefits in terms of EIT tax break or special expense allowances. For example, a duly-verified new software company may be exempt from EIT for first two years and pay EIT at 12.5% for the subsequent three years.

D. INCREASED DIVIDEND WITHHOLDING TAX BURDEN

Prior to the new EIT law, dividends paid by a FIE to an offshore shareholder were exempt from withholding tax in practice. The new EIT (together with the Implementing Measure) sets forth a benchmark dividend withholding tax rate of 10%, and the previously-implemented exemption was not reinstated. However, if a bilateral tax treaty entered into by the PRC sets out a lower withholding rate, that rate would squarely apply.

Therefore a foreign investor should be well aware of the reinstatement of the dividend withholding tax. Where necessary, a foreign investor may be able to reduce the dividend withholding tax burden by taking advantage of bilateral tax treaties (or arrangements) between the PRC and different countries (or regions). For instance, the dividend withholding rate is 5% for dividend paid to companies incorporated in Mauritius, Singapore, Hong Kong SAR, Luxemburg, and so on.

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[Lawrence GUO, the author, can be reached at lawrence_guo@broadbright.com or +86 10 8513 1809]