February 5, 2008

INVESTMENT FUNDS ALERT

CHINA'S NEW ENTERPRISE INCOME TAX LAW AND DETAILED IMPLEMENTATION REGULATIONS

On January 1, 2008, China's new Enterprise Income Tax Law (EIT Law) came into effect. When adopted in 2007, the EIT Law authorized the State Council to issue regulations in regard to implementation of the EIT Law. On December 11, 2007, the Detailed Regulations for the Implementation of Enterprise Income Tax Law (EIT Implementation Regulations) were finally released. Together with the EIT Law, they form the regulatory framework for China's new enterprise tax regime. Many uncertainties remain as to how the Chinese government agencies will interpret and apply the new rules. More supplementary tax circulars are expected in the coming months to provide further guidance.

The EIT Law and EIT Implementation Regulations represent a revamp of China's corporate tax policy and will impact foreign investments in China in many significant ways. Foreign investors will need to review the tax component of their China investment strategies, conduct impact analysis and make necessary adjustments in transaction structures, compliance procedures and reporting mechanisms.

This summary focuses on certain aspects of the new tax regime that may have a particular impact on foreign investment funds that invest in China. A broader overview of the changes in the tax regime and their impact, as well as important updates, may be found in future releases.

TAX RESIDENCY

Prior to the EIT Law, parallel enterprise income tax regimes existed for foreign-invested enterprises in China (i.e., Chinese enterprises with partial or full foreign ownership) (FIEs) and domestic enterprises. The EIT Law unifies the tax rate, incentives and deduction rules by applying a single set of tax laws to all enterprises, including domestic enterprises, FIEs and foreign enterprises. Under the "tax residency" concept introduced by the new regime, each enterprise will be taxed based on its classification as either a tax resident enterprise (TRE) or a non tax resident enterprise (Non-TRE). A TRE is subject to enterprise income tax on worldwide income while a Non-TRE is subject to tax only on its China-sourced income.

TRE

Under the EIT Law, a TRE is an enterprise that is (i) established under the law of China in China or (ii) established under the laws of another country (region) but whose effective management is located in China. The EIT Implementation Regulations define the place of effective management as "the place where the exercises, in substance, of the overall management and control of the production and business operation, personnel, accounting, properties, etc., of a foreign company is located." The concept of tax residency introduced in the new tax regime is a step toward bringing Chinese tax laws into line with international tax principles of focusing on management and control of an enterprise.

The determination of tax residency will most likely involve a facts and circumstances analysis and may vary, depending on China's foreign investment policy. It is expected that offshore companies incorporated in low-tax jurisdictions that have been commonly utilized in "round-trip" investment structures (i.e., Chinese companies setting up foreign holding companies to make investments back into China) would be subject to more scrutiny in determining their tax residency status. Foreign investment funds and managers should carefully review the management and control functions of their investment entities in China and take appropriate steps to avoid being deemed a TRE and exposing their worldwide income to China taxation. A TRE could also be subject to the new CFC rules discussed below.

In addition, the utilization of an appropriate tax treaty jurisdiction to base Non-TRE managers and funds should also now be considered in relation to reducing, in certain circumstances, the risk of being considered to have a Chinese effective place of management.

Non-TRE: Establishment (Branch) in China

The EIT Law provides that where a Non-TRE has an "establishment or place" in China, then such Non-TRE will be subject to taxation on income derived from its establishment or place in China and/or from sources outside China, but effectively connected with its establishment or place in China. Foreign investment managers that do not have a TRE but have advisors or representatives based in or traveling regularly to China should therefore review whether their existing management structure remains tax efficient.

The utilization of an appropriate manager/adviser tax treaty jurisdiction, as opposed to an offshore non-tax treaty jurisdiction-based manager jurisdiction should, in certain circumstances, now be considered and reviewed. In particular, this is a concern for wholly offshore based funds and managers that have Chinese-based managers/advisors.

NEW TAX RATE

The new general enterprise income tax rate is 25 percent. Reduced rates of 20 and 15 percent are available to "qualified small and thin-profit enterprises" and "high/new tech enterprises." The EIT Implementation Regulations specify qualification criteria for qualified small and thin-profit enterprises based on an enterprise's annual taxable income, number of employees and total assets. The EIT Implementation Regulations also define high/new tech enterprises as those that own the core proprietary intellectual property rights and meet certain criteria, including R&D expense and income from high/new tech products. However, the EIT Implementation Regulations leave the formulation of qualification criteria to the relevant government departments.

TAX INCENTIVES/PREFERENTIAL TAX TREATMENT

The new tax regime reflects China's changing foreign investment policy. Preferential treatment is now made available to investments in industries, sectors and projects that are encouraged and supported by the Chinese government, such as technological development, environmental protection and energy conservation. The EIT Law defers to the State Council to adjust the scope of sectors and projects eligible for preferential treatment in accordance with China's needs. Foreign investment funds should monitor the Chinese government's industrial policies on a continuous basis to take advantage of available tax incentives.

One of the available tax incentives concerns investments in venture capital enterprises. The EIT Implementation Regulations confirmed that for a "venture capital enterprise that makes an equity investment in a non-listed small-to-medium sized high/new tech enterprise for more than two years," 70 percent of its investment amount may be used to offset the taxable income of such venture capital enterprise in the year after the holding period has reached two years. Any unapplied portion may be carried forward in the subsequent years.

WITHHOLDING TAX

Under the EIT Law, a Non-TRE will be subject to withholding at source on its gross income from sources in China, provided that such non-TRE has no establishment or place of business in China, or that it has an establishment or place of business in China but the income is not actually connected with such establishment or place of business. The EIT Implementation Regulations define "income" as including income from sale of goods, transfer of property, provision of services, and dividend and profit distributions from equity investment, interest, rental, royalty, receipt of donation and other income. The EIT Implementation Regulations also stipulate the withholding tax rate at 10 percent.

Thus, the new tax regime has removed the exemption available to foreign investors prior to the EIT Law from withholding tax on dividends derived from their FIEs in China. Other China-sourced passive income (including capital gains from sale of Chinese shares) paid by FIEs to Non-TRE foreign investors continues to be subject to withholding at a 10 percent rate. For foreign investment funds that invest in China, the removal of the withholding tax exemption on dividends may increase their tax burden and reduce the expected return from their China investments.

Nevertheless, enterprises from countries that have favorable income tax treaties with China will not be affected by the new 10 percent withholding tax on dividends. Consequently, foreign investment funds should look into tax treaty arrangements that China has with other countries and be prepared to revise their tax planning strategies. For example, foreign investment funds may consider creating a Non-TRE holding company in a jurisdiction that has a favorable double taxation treaty with China to facilitate the repatriation of China-sourced passive income from FIEs in China to foreign investors. However, the EIT Law's new anti-tax avoidance provisions should be taken into consideration in planning effective structures.

Additionally, dividend and profit distributions from equity investments derived by a TRE from its direct investment in other TREs are exempt from withholding tax except for dividends from a listed company if the holding period of the shares is less than 12 months. Hence foreign investment funds should carefully plan their holding structures, including creating a China holding company or an offshore holding company that is deemed a TRE to benefit from the withholding exemption available for TREs.

It should also be noted that the EIT Law does not apply to sole proprietor enterprises or partnership enterprises. Therefore, dividend and profit distribution from a limited partnership in China to foreign investment funds should be exempt from withholding tax.

ANTI-TAX AVOIDANCE PROVISIONS

The EIT Law introduced several anti-tax avoidance rules.

General Anti-avoidance Rule

One notable new concept is the business purpose rule. Article 47 of the EIT Law empowers the tax authorities to make adjustments in cases where an enterprise implements any arrangement with no reasonable business purpose to reduce the amount of taxable income. Article 120 of the EIT Implementation Regulations defined "no reasonable business purpose" as referring to arrangements whose main purpose is reduction, exemption or deferral of tax payments.

Controlled Foreign Company (CFC) Anti-avoidance Rule

Another new feature is the deemed dividend or profit distribution rule whereby a TRE or a Chinese resident individual may be taxed on its portion of undistributed profits as retained by its controlled foreign corporations in certain low-tax jurisdictions without reasonable business reasons.

Thin-capitalization Anti-avoidance Rule

Other anti-tax avoidance measures include a "thin capitalization rule" whereby interest deductions on borrowings from related parties will be disallowed if the interest-bearing loans of the enterprise exceed certain prescribed debt-equity ratios.

The EIT Implementation Regulations do not provide significant elaboration on how these new anti-tax avoidance rules will be applied. Enterprises should implement record keeping and compliance systems and be prepared to justify their transactions to the tax authorities.

Substantial uncertainties still remain as to how the new tax rules will be applied. Foreign investment funds and managers will need to carefully study the impact of the new rules on their existing and future investments in China and watch for tax circulars that are expected to be issued that will provide more guidance.

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