Enterprise Income Tax Planning in China

by Jinji Wei

Jinji Wei (Glen Wei) is a Chinese certified tax adviser and Chinese lawyer and is the tax manager at the Shenzhen office of BDO International. E-mail: glenwei.china@yahoo.com.

All rights reserved.

Since January 1, 2008, China has been implementing a new enterprise income tax system, under which all domestic enterprises, foreign investment enterprises, and foreign enterprises are subject to the uniform Enterprise Income Tax Law (EITL) and Implementation Regulations for Enterprise Income Tax Law (EITLIR), as well as a series of circulars issued by government agencies. This article focuses on tax planning ideas and highlights matters for foreign investment enterprises and foreign enterprises under the new system.

Effective Management

An enterprise established under the law of another foreign country or region but having its place of effective management in China will be treated as a Chinese resident enterprise and will be subject to EIT on its worldwide income (EITL, article 2, 3). Effective management is defined as a kind of management that exercises substantial overall management and controls over the production and business operations, personnel, accounting, and properties of an enterprise (EITLIR, article 4).

To avoid being recognized as a Chinese resident enterprise, a foreign enterprise incorporated outside China, particularly when it is located in a country or region that has a lower enterprise income tax rate (less than 25 percent), may properly arrange its business activities when carrying on China-related business activities.

Overseas Income

Besides Chinese-source income, overseas income will be taxed on an establishment incorporated by a nonresident enterprise in China if the overseas income is effectively connected with the establishment (EITL, article 3). Effectively connected income refers to income derived from shareholdings and creditor’s rights of the establishment and other properties owned, managed, and controlled by the establishment (EITLIR, article 8).

To avoid overseas income effectively connected with China, a nonresident enterprise incorporated outside China may make appropriate arrangements on its business activities, shareholding structure, creditor’s rights, and other properties when operating business through its establishment in China.

---


3A region is an area that is not a country but has its own law system, such as the Hong Kong Special Administrative Region of the People’s Republic of China or the Macao Special Administrative Region of the People’s Republic of China.
Accrual Basis

Taxable income will be calculated on an accrual basis unless otherwise stipulated in the EITLIR or by the competent finance and taxation departments of the State Council (EITLIR, article 9).

For tax planning purposes, an enterprise, when necessary, may make appropriate arrangements on its production and business operations to defer the recognition of revenue and accelerate the incurring of expenses based on related supporting documents.

Preferential Tax Treatment

HNTE

A high-new technology enterprise (HNTE) specifically supported by the state is entitled to a reduced tax rate of 15 percent (EITL, article 28). Furthermore, an HNTE will also enjoy a tax holiday consisting of a two-year exemption and a three-year 50 percent tax reduction on its income derived within the special economic zones (SEZs) or the Shanghai Pudong new area, provided that the HNTE is an enterprise newly established in the SEZs or the area from 2008 onward and operates its business activities in the SEZs or the area.

The tax holiday begins from the tax year when the HNTE gains its first revenue from the production and business operations. To enjoy the tax holiday, it is advisable to establish and operate an HNTE in the SEZs or the area rather than other locations on or after January 1, 2008.

A high-new technology enterprise is subject to a series of strict conditions and requirements.

However, an HNTE is subject to a series of strict conditions and requirements. On April 14, three Chinese government agencies (the Ministry of Science and Technology, the Ministry of Finance, and the State Administration of Taxation) jointly issued "Administrative Rule for Verification of High-New Technology Enterprises," which states that an HNTE refers to a resident enterprise:

- whose products or services fall within the "Scope of High-New Technology Specifically Supported by the State" (the Scope);
- that continuously performs the research and development activities and the transformation of technological achievements, forms its core proprietary intellectual property rights, and carries on business activities on such basis;
- whose registered address is located within China, excluding Hong Kong, Macao, and Taiwan; and
- whose creation is more than one year from the date of establishment.

The Scope covers only eight areas: electronic information technology, biological and new medical technology, aeronautics and space technology, new material technology, high-tech service industries, new energy and energy saving technology, resource and environment technology, and traditional industry reform through high-new technology. Before enjoying the tax incentives, an HNTE must obtain a Certificate for High-New Technology Enterprise from the verification administration institute and an approval in writing from the competent tax authorities.

Qualified Small-Scale Enterprise

A qualified small-scale enterprise may enjoy a reduced tax rate of 20 percent (EITL, article 28). When prepaying EIT for the first time in a current year, an enterprise will submit relevant supporting documents of being qualified as a small-scale enterprise in the last year to the tax authorities for review. Thus, a qualified small-scale enterprise will not miss the required period of providing the supporting documents and applying for the reduced tax rate of 20 percent.

A qualified small-scale enterprise refers to an enterprise that is engaged in a nonrestricted and nonprohibited industry and meets the following criteria:

- for industrial enterprises: annual taxable income, total assets, and number of staff do not exceed RMB 0.3 million, RMB 30 million, and 100 persons, respectively; and
- for other enterprises: annual taxable income, total assets, and number of staff do not exceed RMB 0.3 million, RMB 10 million, and 80 persons, respectively (EITLIR, article 92).

Transfer of Equity

Dividend income received by a resident enterprise from direct investments in other resident enterprises will be exempt from EIT, except the dividend income gained from publicly traded resident enterprises in which the enterprise continuously holds the stocks for less than 12 months (EITLIR, article 83). Capital gains from the disposal of equity will be taxable and included in taxable income of the current year. Thus, for tax planning purposes, undistributed profits generated

---

by a resident enterprise may be paid to its shareholders, as resident enterprises, before the transfer of equity in the resident enterprise. However, this does not apply to the transfer of equity in a foreign investment enterprise in which its undistributed profits are all generated from 2008 onward, because those profits, when distributed to its shareholders, are no longer exempt from EIT.7

Assignment of Technology
Up to RMB 5 million of income earned by a resident enterprise from the assignment of technology within a tax year will be exempt from EIT, and the remaining income in excess of RMB 5 million will be allowed a 50 percent tax reduction (EITLIR, article 90). To save tax, income derived from the assignment of technology may be recognized on a year-by-year basis in accordance with the terms of relevant agreements and other supporting documents through prior appropriate arrangements, if the income from the assignment exceeds RMB 5 million.

R&D Expenses
Research and development expenses incurred in connection with the development of new technology, new products, and new craftsmanship will be deductible on a basis of 150 percent (EITLIR, article 95). A global group may consider moving its R&D department to China if the group could benefit from this move.

Special Fixed Assets
A shorter depreciation period or one of the two accelerated depreciation methods may apply to the depreciation of fixed assets that need to be replaced quickly because of the development of technology, or that are subject to constant and frequent strong vibrations or easy corrosion (EITLIR, article 98). When necessary, an enterprise may apply for such accelerated depreciation if the conditions are met.

Special Equipment
Ten percent of the purchase cost of special equipment may be offset against EIT payable in the tax year of purchase, and the excess amount may be carried forward to the next five years if the special equipment (for environmental protection, energy and water saving, and production safety) is purchased and actually used by enterprises and listed in the “Category of Preferential Enterprise Income Tax Treatment for Environmental Protection Special Equipment,” “Category of Preferential Enterprise Income Tax Treatment for Energy and Water Saving Special Equipment,” and “Category of Preferential Enterprise Income Tax Treatment for Production Safety Special Equipment,” respectively (EITLIR, article 100). As such, an enterprise should apply for the tax incentives when purchasing and using such special equipment. However, an enterprise will not benefit from the tax incentives and must repay the amount of EIT already offset if the special equipment is sold or leased out within five years from the date of purchase.

Special Raw Materials
Only 90 percent of total revenue from the sales of products will be taxed if the main raw materials used to manufacture the products are listed in the “Category of Preferential Enterprise Income Tax Treatment for Comprehensive Utilization of Resources,” are non-restricted and nonprohibited by the state, and satisfy the national and industry relevant standards (EITLIR, article 99). It is advisable for an enterprise to check whether it is entitled to enjoy the preferential tax treatment when the category is issued.

Encouraged Industry
The new tax system has provided preferential tax incentives to some industries, including but not limited to:

- **Software Development Industry.** Qualified newly established software enterprises qualify for a tax holiday consisting of a two-year exemption and a three-year 50 percent tax reduction. Qualified key software development enterprises qualify for a reduced tax rate of 10 percent if they fail to enjoy EIT exemption in the current year.8
- **Integrated Circuit Industry.** Subject to different conditions, qualified production-oriented integrated circuit enterprises qualify for two types of tax incentives — a tax holiday consisting of a “two-year exemption and three-year 50 percent tax reduction”; or a reduced tax rate of 15 percent and a tax holiday consisting of a “five-year exemption and five-year 50 percent tax reduction.”9
- **Security Investment Fund Industry.** An exemption from EIT is provisionally granted to security investment funds, security investment fund managers, and the investors of security investment funds on some income.10
- **Qualified Venture Capital Enterprises.** Up to 70 percent of total investments may be allowed to set off against taxable income of such enterprises.11
- **Qualified Environmental Protection and Energy and Water Saving Projects.** These projects qualify

---

9Id.
10Id.
11See EITLIR, article 97.
for a three-year exemption and a 50 percent tax reduction for the subsequent three years.\textsuperscript{12}

- **Qualified Infrastructure Development Projects.** These projects qualify for a three-year exemption and a 50 percent tax reduction for the subsequent three years.\textsuperscript{13}

- **Qualified Agriculture, Forestry, Animal Husbandry, and Fishing Projects.** Subject to different conditions, these projects qualify for a tax exemption or a 50 percent tax reduction.\textsuperscript{14}

### Antiavoidance Rules

#### Advance Pricing Agreement

An enterprise may reach an advance pricing agreement with the tax authorities through negotiations and by raising transfer pricing principle and calculation basis regarding future related-party transactions (EITL, article 42; EITLIR, article 113). An APA must be based on the arm’s-length principle. To avoid or reduce tax risks, an enterprise may sign an APA with the tax authorities.

#### Cost Contribution Agreement

Costs incurred between an enterprise and its associated enterprises in connection with the joint development or purchase of intangible assets, or with the joint provision or acquisition of services, will be allocated in accordance with the arm’s-length principle when calculating taxable income (EITL, article 41). The costs allocated by an enterprise will not be deductible if:

- a cost contribution agreement is not signed;
- the contribution of costs violates the matching principle of associated costs and expected revenue; or
- relevant supporting documents are not submitted to the tax authorities within the prescribed period (EITLIR, article 112).

Therefore, an enterprise will comply with the aforementioned requirements when incurring joint costs with its associated enterprises.

#### Business Purpose Test

The EITL provides a general antiavoidance rule that the tax authorities will reserve the right to make adjustments based on reasonable methods within 10 years commencing from the tax year when these arrangements occur, if an enterprise performs other arrangements without reasonable business purpose resulting in the reduction of its taxable revenue or income (EITL, article 47; EITLIR, article 123). Arrangements without reasonable business purpose refer to arrangements whose main purpose is to reduce, evade, or defer tax payments (EITLIR, article 120). Thus, an enterprise will arrange its business activities carefully so as not to violate the rule.

### Deductions

#### Management Fees

An enterprise may pay management fees to other enterprises because of some business transactions or purposes. Before 2008, management fees paid by a foreign investment enterprise to its associated enterprises were not deductible (Implementation Rules for Foreign Investment Enterprise and Foreign Enterprise Income Tax Law,\textsuperscript{15} article 58). Beginning in 2008, management fees paid between enterprises will not be deductible (EITLIR, article 49). A difference exists between the two clauses. There is no further clarification regarding the definition of management fees. To avoid potential adverse consequences, an enterprise should consider using phrases like “service fees” rather than “management fees” when signing service agreements with, and receiving invoices from, other enterprises.

#### Employee Commercial Insurance

An enterprise usually purchases commercial insurance on behalf of its employees. However, commercial insurance paid by an enterprise to its staff will not be deductible unless otherwise stated by the competent finance and taxation departments of the State Council (EITLIR, article 36). Commercial insurance expenses may be changed to employee salary expenses and be included and reflected in relevant salary sheets in a current month. The employees may then purchase the commercial insurance directly, with the employer acting as an agent when necessary. Under this model, the salaries (covering the commercial insurance) will be deductible if the total amount of the salaries falls within the reasonable scope. (Note: The individuals are subject to the same amount of individual income tax regardless of whether the income is paid as salary or commercial insurance.)

#### Sponsorship Fees

Sponsorship fees are not deductible (EITL, article 10). Sponsorship fees refer to various expenditures that are unrelated to the production and business activities of an enterprise and have no advertising nature (EITLIR, article 54). Sponsorship fees may be changed to advertising fees through appropriate business arrangements.

\textsuperscript{12}See EITLIR, article 88.

\textsuperscript{13}See EITLIR, article 87.

\textsuperscript{14}See EITLIR, article 86.

Advertising and Sales Promotion Fees

Before 2008, all advertising and sales promotion fees incurred by a foreign investment enterprise could be recorded as expenses and deducted in the current tax year. However, since 2008, the deductible amount in the current tax year is limited to a maximum of 15 percent of annual sales (business) revenue for that tax year, and the excess amount may be carried forward into the following tax years (EITLIR, article 44).

Entertainment Fees

Before 2008, all entertainment fees could be deducted from taxable income if some conditions were met. However, since 2008, the deductible amount is strictly limited to both 60 percent of the entertainment fees incurred by an enterprise in relation to the production and business operations, and 0.5 percent of annual sales (business) revenue for that tax year, with the lower amount prevailing (EITLIR, article 43). Therefore, an enterprise should plan and control entertainment fees.

Public-Welfare-Purpose Donations

Before 2008, qualified public-welfare-purpose donations made by a foreign investment enterprise were fully deductible. However, since 2008, donations are deductible up to a limit of 12 percent of annual before-tax accounting profits of the current tax year if they are made by an enterprise through qualified nonprofit social organizations, the government at the county level or above, or the departments of the government, and if they are used for public welfare purposes stated in the Public Welfare Donation Law of the People’s Republic of China (EITLIR, article 51, 53). Thus, when making such donations, an enterprise should consider and forecast carefully whether or not the total amount of donations would exceed 12 percent of before-tax accounting profits in that tax year. If positive, the excess amount may be deferred to donate in the following years rather than in the current year. Also, as a donor, an enterprise must keep in mind that any donations made directly to donees are not deductible (EITL, article 10).

Foreign Loan Rate

Sometimes a foreign investment enterprise borrows money from its foreign investors or other foreign entities and pays interest accordingly. Under the EITLIR, for the interest expenses incurred by the foreign investment enterprise during the course of the production and business operations, the deductible amount is limited to the amount calculated by using a loan interest rate set by Chinese financial institutions under the same period and type of loan, and the excess amount will not be deductible. As such, when a higher interest rate is provided in relevant loan agreements, the borrower will not receive any additional tax benefits. However, the foreign lender will be subject to more business tax (a kind of turnover tax, similar to VAT) and EIT (on a withholding basis) as a result of earning more interest income, except for some special tax-exemption circumstances.

Supporting Documents

For an establishment incorporated by a nonresident enterprise in China, expenses incurred by its overseas head office in connection with the production and business operations of the establishment will be deductible if the establishment can provide relevant supporting documents issued by the head office and the expenses can be reasonably allocated (EITLIR, article 50). Therefore, such establishment should gather and keep relevant supporting documents in a timely and proper manner so that they can be provided to the tax authorities.

Property Insurance

Property insurance expenses paid by an enterprise in accordance with relevant provisions will be deductible (EITLIR, article 46). Generally an enterprise may select qualified insurance institutions in China rather than foreign insurance institutions to avoid potential nondeductible consequences.

Other Matters

EIT Exemption on Specific Dividends

Although newly increased profits derived by a foreign investment enterprise from 2008 onward are no longer exempt from EIT when they are distributed to its foreign investor, undistributed profits generated before 2008, but paid to its foreign investor from 2008 onwards, are still exempt from EIT. Therefore, during the distribution of those profits generated before 2008, a foreign investment enterprise should clearly state the attributed year of the profits on relevant documents when applying for EIT exemption, especially when the home country of the foreign investor allows tax-sparing credits that apply to the exemption from EIT on the dividends.

EIT Refunds for Qualified Reinvestments

A foreign investor that directly uses its after-tax profits gained from a foreign investment enterprise as capital to either increase the enterprise’s registered capital or to establish another foreign investment enterprise may apply for a tax refund for the reinvestments of the after-tax profits in accordance with the Foreign Investment Enterprise and Foreign Enterprise Income Tax Law (FIETL), provided that the reinvestment


matters had been completed and the change of the enterprise’s registered capital or the incorporation of the new enterprise had been registered with the competent industrial and commercial administration department by the end of 2007. In short, a foreign investment enterprise should apply for tax refunds for qualified reinvestments. However, a tax refund is not available for the reinvestments of profits that are generated during 2007 but predistributed by the end of 2007.

Obtaining Approval

In China preferential tax treatment is not automatically granted to taxpayers, although tax laws have provided the tax treatment. According to Guoshuifa (2005) No. 129, some preferential items are subject to approval from the tax authorities while others are subject to filing with the authorities before taxpayers are entitled to benefit from them. In some cases, foreign investment enterprises miss the opportunity to enjoy tax relief treatment because of ignorance of or delay in performing the required procedures.

Calculating Income Separately

Taxable income on the projects with preferential tax treatment will be calculated separately and the same-period expenses will be allocated reasonably if an enterprise is engaged in such projects. The enterprise will not be entitled to enjoy the preferential treatment if failing to calculate the taxable income separately (EITLIR, article 102).

Statutory Invoices

To incorporate a foreign investment enterprise in China, it is common that a foreign investor, as required, sign a property lease agreement before the new enterprise is established. Generally speaking, the property is used and rent costs are borne by the new enterprise; however, rental invoices are sometimes issued to the foreign investor even if it has been established for a period of time. In China a statutory invoice is considered one of the most important supporting documents for tax purposes. The rental costs will not be deductible if an incorrect invoice is issued or there is no invoice. To avoid potential adverse consequences, it is advisable to change the name of the lessee stated in the lease agreement from the foreign investor to the new enterprise once it is established, and the new enterprise, rather than its foreign investor, will be invoiced.

Business Nature or Operating Period

A foreign investment enterprise will be required to repay the amount of tax already exempted or reduced in accordance with the FIETL when the foreign investment enterprise, in or after 2008, no longer meets relevant requirements stated in the FIETL because of the change of its business nature or operating term. In sum, a foreign investment enterprise should consider potential tax repayment consequences carefully before changing the business nature or shortening the operating period.

Withholding at Source

Withholding at source will apply to income tax payable levied on Chinese-source income derived by a nonresident enterprise, with the payer acting as a withholding tax agent; the tax amount will be withheld from the payment or payment due when each payment is made or due (EITL, article 37). For tax planning purposes, the payment date and due date should be properly arranged on the interest, royalties, dividends, and other Chinese-source income earned by foreign shareholders from their foreign investment enterprises in China.

---

18 Guoshuifa (2008) No. 23, circular issued by the SAT on February 27, 2008.

19 Guoshuifa (2008) No. 23. A typical example is that a production-oriented foreign investment enterprise will be required to repay the tax benefits from the tax holiday of the two-year exemption and three-year 50 percent tax reduction if it is closed before its 10-year operating period is complete (except for special circumstances).