THE LEGAL ENVIRONMENT OF CORPORATE INCOME TAXATION FOR FDI IN CHINA: POLICY, CHANGES, RISKS

by

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ABSTRACT

Foreign direct investment (FDI) was unknown to Chinese people before the opening policy in 1979, but since then China’s economy has been surging ahead in the past twenty eight years. As one aspect of the FDI policy, I focused on the corporate taxation field to be my research interest, and the topic of my thesis.

In the thesis, the reader will learn how FDI developed in China and degree of FDI development. Also, I provide the reader with China’s tax system and policy-oriented in as much detail as possible, most of which is the tax incentive policy towards the FDI in China. However, the policies and incentives raise some issues. As the result of offering FDI tax preference, Chinese government tax revenue as a percentage of GDP has been declining steadily. Problems such as tax avoidance and evasion, and local “fake” FDI entities are getting serious.

The new Corporate Income Tax Law of the People’s Republic of China (CIT Law) was passed by the PRC National People's Congress on March 16 2007 and will take effect on January 2008. When China entered into the World Trade Organization (WTO) in 2001, compliance with the general rules required China improve its tax system as soon as possible. The CIT law section in the thesis includes the policy-changing behind the legislation and expected influence on the FDI in China in the future. As a result of the changes to be brought about by the CIT Law, foreign and domestic business in China must adapt to the new tax regime, and I offer some recommendations in that regard.
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Introduction

Foreign direct investment (hereinafter "FDI") in China was initially authorized in 1979, as part of the economic reform and open-door policy launched in December 1978. FDI was unknown to Chinese people before 1979; however, it became very well known subsequently.

Chapter 2 contains a general overview of the development of FDI in the years since 1978. Chapter 3 describes China's tax system and policy-orientation in some detail, with a focus on the tax incentive policy towards the FDI. Chapter 3 also contains an international comparison and reference to tax incentive policies elsewhere.

China faces the challenge of designing and carrying out reform of its tax system following its transformation from central planning to a market economy. Among the various incentives to draw FDI into China, tax incentives are probably the most attractive for foreign investors. FDI policies and tax incentives have been significant influences on the growth, regional distribution, and technology embodied in FDI.

However, the policies and incentives raise some issues that are discussed in Chapter 4. As the result of offering tax preferences to FDI, Chinese government tax revenue as a percentage of GDP declined. In some areas, local governments collected fees without reasonable rules, which led to corruption. Some of the planning around FDI involves tax avoidance, and even evasion. Experts believe that tax evasion is a possible cause for the lack of growth in tax collections. Since FDI receives incentives that are unavailable to domestic enterprises, local companies may set up "fake"
entities to take advantage of FDI incentives. Although tax reform has made progress in creating equity and fair competition, problems remain to be resolved in the future. Chapter 4 also discusses some international tax issues that China is facing.

Chapter 5 describes the new Corporate Income Tax Law of the People's Republic of China (hereinafter the "CIT Law") which was passed by the PRC National People's Congress on March 16 2007, and will take effect on January 2008. The CIT Law has been widely discussed in the past few years, and it is the result of those ongoing discussions. Actually, as discussed in Chapter 3, China does not have a tax system that works very well for foreign investment. However, when China entered into the WTO in 2001, China was required to improve its tax system as soon as possible in order to comply with the WTO general rules. Chapter 5 describes the CIT Law under four topics: (1) the policy changes behind the legislation; (2) the WTO rules related to the changes; (3) the main changes introduced by the new law; and (4) the expected influence on FDI in China in the future. A conclusion will be provided after Chapter 5.

Since there are some phases which are widely used throughout the thesis, a glossary of abbreviations will be attached followed by three appendixes. Appendix I contains the Sino-foreign tax treaties for the avoidance of double taxation. Appendix II contains a summary of key aspects of the CIT Law. The last appendix contains the full text of the new Corporate Income Tax Law of the People's Republic of China.
Chapter 2 FDI in China

Nowadays, FDI has become the basic means of China's absorption of foreign investment. Theoretically, foreign investment can be divided into direct investment and other means of investment. Direct investment, which is widely adopted, includes Sino-foreign joint ventures, foreign-funded share-holding companies and joint development. The other means of investment includes compensation trade and processing and assembling.

FDI\(^1\) played a major symbolic role in the opening up of the Chinese economy twenty seven years ago when China embarked upon a journey to the market economy. However, after the new China was founded in 1949, the country's connection with the "outside world," especially economically advanced western nations, was limited and curtailed (Shirk, 1994). Domestically, the communist government called for economic self-reliance, whereby China reacted to the West by "closing the door."

The "door was opened" after the economic reforms initiated in 1978. At that time, the Chinese government began to realize that economic self-reliance would not be enough to fuel China's economic development. Rather, China would have to reach out and seek connections with other nations. China's leaders set the goal of turning China into an economically developed nation by achieving what they called the "four modernizations", the modernization of industry, agriculture, national defense, and

\(^1\) In this thesis, unless otherwise indicated, I refer to FDI actually used by China.
science and technology. They were determined to catch up to the western developed nations, and by necessity to broaden China’s connections with them.²

The “open door” policy was the first step toward rejoining the outside world. The first test of this policy was the establishment of special economic zones (SEZs) as “windows” for international trade and FDI.³ In these SEZs, measures of market operation were introduced and enterprises were granted special preferences to attract foreign capital and technologies. The trial project turned out to be very successful: in 1980, the foreign currency holdings of Guangdong and Fujian, where the four SEZs are located, rose to six times their 1979 levels (Gross, 1988). Recognizing the dramatic increase, the central government quickly granted similar preferences to Hainan Island and 14 coastal cities in 1984; to the entire coastal zone in 1988; to Shanghai in 1990; and to 21 additional (non-coastal) cities along the Yangtze river and in the northeast in 1992 (Shirk, 1994; Wang, 1996; Yan, 1992).

After the “open door” policy was implemented China’s foreign trade increased at an unprecedented rate. From 1978 to 2003, the country’s trade increased at an average annual rate of 15 per cent, and its share of total world trade increased from less than one percent to more than five percent, while its national ranking in world trade (merchandise) jumped from 32nd place in 1978 to third place in 2004 (after the US

<http://jds.sagepub.com/cgi/content/abstract/22/2/197>
³ In 1979, Shenzhen, Shantou and Zhuhai became the first three SEZs, and Xiamen became the fourth SEZ in 1980.
Along with foreign trade, foreign investment has increased dramatically as well and as an important indicator of total foreign investment, in the past 20 years from 1979 to 1999, total accumulated FDI in China reached about 400 billion US dollars and China was the third largest recipient (cumulatively) after UK and US.⁴

When China entered into WTO in 2001, FDI also commenced a new era. FDI attracted into China reached the historic high of US$60.63 billion in 2004. The actual FDI in 2005 was US$72.41 billion dollars which marks a 19.4 per cent year-on-year growth over 2004.⁵ However, the FDI in 2006 was US$69.468 billion, a decreased 4.06 per cent as compared with that of the same period in 2005. The growth trend of FDI slowed down slightly with a small decrease on a year-on-year basis.⁶


⁵ “FDI has more advantages than disadvantages”, online: Chinafiw <http://www.chinafiw.com/e_m/site/mysystem390.asp?trans_infoid=57480>

⁶ “FDI has more advantages than disadvantages”, online: Chinafiw <http://www.chinafiw.com/e_m/site/mysystem390.asp?trans_infoid=57480>

⁷ According to the official statistics, in 2002, FDI in China increased by a large margin, 34,171 foreign-invested enterprises were newly set up. The actual utilized FDI of 2002 was US$52.743 billion, an increase of 12.51 per cent over 2001. In 2003, FDI in China still increased by a small margin under the influence of SARS, and the actual utilized foreign investment in China maintained on the top globally. In the same year, the FDI was US$53.505 billion, an increase of 1.44 per cent over 2002. In 2004, the actual utilized FDI was US$60.630 billion, an increase 13.32 per cent over 2003. In 2005, the actual utilized FDI was value of US$72.406 billion, an increase of 19.42 per cent over 2004.

This chapter describes how FDI developed in the past few years in China and the current importance of FDI.

2.1: FDI in China (1979–mid-2007): An overview

As a developing country, China requires foreign capital to finance its economic growth. During the past few years, China has attracted a huge amount of foreign investment. Where there is an opportunity to make profits, it will attract foreign investment unless it is prohibited. A foreign investor, in deciding whether or not to invest in a country such as China, must take into consideration many factors. The most important may be the policies toward foreign investment that the Chinese government pursues from time to time. Policies may succeed or fail in attaining their intended objectives. If the Chinese government decides that a policy is failing to achieve its intended objective, the government can and will change the policy. This section of the thesis reviews the recent history of China’s policy development toward foreign investment, as a long process of trial and error.

The growth of FDI in China has been dramatic since the beginning of the economic reforms in 1978. China is now the second largest recipient of foreign capital in the world (behind the United States). The expansion of FDI in China has been accompanied by rapid economic growth and an open-door to the rest of the world.

FDI represents the most important source of foreign capital in China, surpassing foreign borrowing for the first time in 1992. Before 1979, no foreign-owned enterprise operated in China as foreign money was viewed with suspicion by Chinese leaders. The Open Door Policy introduced by Deng Xiaoping, who was the vice
premier of PRC, in 1979 involved a different attitude towards FDI. This change can be explained by two major factors: the disastrous economic performance before 1979; and the successful examples of Japan and the four Asian Tigers.8

2.1.1 Development of FDI in China

Soon after the Third Plenum of the 11th Central Committee of the Chinese Communist Party, the prohibition of FDI in China, which had been in force since 1949, was lifted. Deng Xiaoping promoted FDI reforms, acknowledging that foreign investment might increase foreign capital, attract advanced technology and develop the manufacture of products for export, to create jobs and earn foreign exchange.

China enacted its first foreign investment law affecting FDI, the Equity Joint Venture Law9 in 1979. The aim of this law was to limit the establishment of foreign firms in China in three ways: (1) geographically, to the four SEZs and in the coastal areas;10 (2) organizationally, to equity joint ventures (discussed in 2.1.2 Legal Forms of FDI in China); and (3) sectorally to hotel construction and energy extraction. The government did not want foreign owners to develop China’s natural resources and a

8 Hong Kong, Taiwan, Singapore, and South Korea
9 In order to create a favorable investment environment and to encourage overseas firms to invest in China, since the year of 1979 the Chinese government has gradually set up a relatively complete legal system, and constituted a foreign investment policy system, which mainly includes industrial policies, regional policies, tax policies and financial polices. “Foreign Investment Policy System”, online: GOV, <http://www.gov.cn/english/2005-08/30/content_27397.htm>
10 Four Special Economic Zones: Shenzhen, Zhuhai, Xiamen, Shantou. See figure 1 which shows the SEZs and coastal cities geographically as follows.
similar nationalistic policy was pursued by other nations. However, the Chinese government removed each of these restrictions over time. Almost every region of China is now eligible for FDI, every sector welcomes foreign investment and foreign investors can choose the organizational structure under which their capital is invested in China.

Figure 1 Special Economic Zones

Source: www.landingchina.com

Removed for copyright reasons
The objective of soliciting FDI, as mentioned in various Chinese documents,\textsuperscript{11} were as follows: (1) to develop a diversified industrial base; (2) to introduce and import new technology; (3) to stimulate economic growth; (4) to upgrade managerial and labour skills; and (5) to increase exports, especially manufactured goods.

Despite the Equity Joint Venture Law, the flow of FDI into China was not so rapid, nor has the outcome been so successful, as foreign investors or Chinese officials had hoped. From 1979 to 1983, was a period of sluggish increase. From 1984 to 1991, the inflows of FDI increased. In the most recent phase, from 1992, the large-scale expansion of FDI has made China the second largest recipient of FDI in the world.

Before 1983, the growth rate of FDI was quite modest. The number of projects was nearly constant, increasing only from 230 in 1979 to 396 in 1983 (the value increased from $0.5 billion in 1979 to $1.5 billion in 1983). During this phase, many foreign investors adopted a wait-and-see attitude, wanting more information before investing in China. The predominance of investors from Hong Kong and Macao was mostly due to geographic and cultural proximity rather than to incentives offered by the Chinese authorities.

\textsuperscript{11} The Equity Joint Venture Law of PRC (1979) and Provisions of the State Council for the Encouragement of Foreign Investment (Promulgated on October 11, 1986) (guan yu gu li wai shang tou zi de gui ding). Article 1 of the Provisions provided:

"These Provisions are formulated in order to improve the investment environment, facilitate the absorption of foreign investment, introduce advanced technology, upgrade product quality, expand exports in order to generate foreign exchange and develop the national economy."
After 1983, with the extension of the legal framework and the greater flexibility given to foreign investors, foreign investment grew faster. However, the absorption of FDI in China had been too low for the Chinese authorities. Furthermore, the nature of the foreign enterprises was unsatisfactory to Beijing. These enterprises had been too small with low levels of capitalization and less-advanced technology. The economic environment had not encouraged foreign investors to build advanced-technology firms in China. The main reasons were the incomplete legal system, the low quality of labour, and the difficulties in obtaining some raw materials. Some investors threatened to withdraw from their projects in China if the investment environment did not improve. The initial foreign investment law contained many restrictive provisions that potential foreign investors regarded as being unreasonable and the Chinese government was aware of that and took action to move these restrictions.

In 1986, the Chinese leaders decided to restore foreign investors’ confidence by implementing incentives for the foreign business community. On October 11, 1986, the State Council promulgated the Provisions of the State Council of the PRC for the Encouragement of Foreign Investment which was called “twenty-two Article Provisions”. The Provisions provided foreign joint ventures with preferential tax treatment, the freedom to import inputs such as materials and equipment, the right to

12 The Equity Joint Venture Law provided such as access by joint ventures to the Chinese domestic market was limited and no provision for wholly foreign-owned companies.
retain and swap foreign exchange with each other, and simpler licensing procedures. Additional tax benefits were offered to export-oriented joint ventures and those employing advanced technology. In a nutshell, four sets of incentives were offered as follows: (1) there were reductions in land use fees, taxes, the cost of some inputs, and the wage rates paid by Foreign-Fund Enterprises (hereinafter “FFE$s”); (2) access to inputs controlled by the state was improved (water, electricity, communication, transportation and Renminbi (Chinese currency loans)); (3) there was an attempt to improve bureaucratic efficiency (especially in foreign investment project authorizations) and (4) greater flexibility was guaranteed in decisions on production, export, import and employment. From then on, FDI in China entered into a continuously developing stage.

Foreign investors responded favourably to the new incentives and FDI started to increase again. Between 1986 and 1991, the total actual FDI was US$ 16.7 billion, which increased 255.3 per cent compared with the previous period.

The main source of FDI to China originates from the Asia-Pacific region (74.5 per cent of total FDI stock comes from the East Asian Newly Industrialized Economies—“NIE$s” hereinafter). Hong Kong has always been China’s major investor. It accounted for 61 per cent of FDI stock in 1994. Hong Kong investors have concentrated their investment in traditional industries such as metal products, garment manufacturing, textiles, electronics and plastic conversion. With 8.72 per cent of the total accumulated inflows, Taiwan is the second most important source of foreign capital in China. The Taiwanese began to invest massively in China from the 1990s
onwards. In addition, the United States, Japan and other developed countries in Europe have also contributed to FDI in China.

The total trade value exchanged between China and US was less than 1 billion US dollars in 1978, yet it reached 97 billion dollars in 2002. In 2004, the number topped 169.6 billion dollars, and the US surpassed Japan to become China’s second largest trade partner (after the expanded European Union). Moreover, it was reported in 2002 that for every one percent increase in the US economy, China’s exports to the US will increase by 10 percent. The United States is another important investor with 8 per cent of the FDI stock in 1994 (the third largest source), but it declined to fifth place by 2005. Although Western European countries are the main source of international direct investment in the world, their share in China is relatively small: only the UK’s share in FDI stock is more than 1 per cent.

2.1.2 Legal Forms of FDI in China

The legal and institutional framework for FDI has been elaborated progressively and has been part of the building up of a modern economic legislation in China. Three main legal regimes exist for FDI: (1) Equity Joint Venture (hereinafter “EJV”); (2) Cooperative (contractual) Joint Venture (hereinafter “CJV”); (3) Wholly Foreign-Owned Enterprise (hereinafter “WFOE”).

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14 “Sino-US trade relationship” online: china-embassy,
<http://www.china-embassy.org/chn/zmgx/t222162.htm>
(1). Equity Joint Ventures (EJVs)

EJVs are also known as share-holding corporations. They are formed in China with joint capital by foreigners and by Chinese. The joint parties invest together, operate together, share risk according to the ratio of their capital and bear losses and share profits in the same ratios. The capital from different parties is translated into the ratios of capital, and in general the capital from the foreign party should not be less than 25 per cent. EJVs were among the first forms of China's absorption of FDI, and they continue to play a great part at the present time.

(2). Cooperative (Contractual) Joint Ventures (CJVs)

CJVs are also called contractual cooperation businesses according to Chinese translation. They are formed in China with joint capital or contractual terms of cooperation by foreigners with Chinese. The rights and obligations of different parties are described in the contract. To establish a cooperative business, the foreign party, generally speaking, supplies all or most of the capital while Chinese party supplies land, factory buildings, and useful facilities, but some Chinese parties supply capital, too.

(3). Wholly Foreign-Owned Enterprises (WFOEs)

WFOEs are entirely foreign-owned investments by foreigners, in accordance with the laws of China.\textsuperscript{15} According to the law governing foreign-funded enterprises,\footnote{Law of the PRC on Foreign-Capital Enterprises was adopted at the Fourth Session of the Sixth National People's Congress, promulgated by Order No. 39 of the President of the People's Republic of China and effective as of April 12, 1986.}
their establishment should benefit the development of China’s national economy and conform to at least one of the following criteria: (1) the enterprises must adopt international advanced technology and facility; or (2) all or most of the products must be export-oriented. The foreign funded enterprises often take the form of limited liability. China is also exploring and expanding actively its new types of utilizing foreign investment such as BOT, Investment Company and so on. Since multinational merger and acquisition has become the major type of international direct investment, the Chinese government is now researching and enacting policies so as to facilitate foreigners’ investment in China by means of merger and acquisition.16

In 2002, FDI in China increased by a wide margin, and the actual utilized foreign investment in China rose to first place in the world. In the same year, 34,171 foreign-invested enterprises were set up, with a contractual foreign investment of US$82.768 billion and an actual foreign investment of US$52.743 billion, an increase of 30.72 per cent, 19.62 per cent and 12.51 per cent over 2001 respectively. The 5 countries/regions investing the most in China in 2002 were: Hong Kong (US$17.861 billion), the Virgin Islands (US$6.17 billion), the U.S. (US$5.424 billion), Japan (US$4.19 billion) and Taiwan Province (US$3.971 billion).17

accordance with relevant Chinese laws. The term does not include branches set up in China by foreign enterprises and other foreign economic organizations.

17 The proportion of China’s actual utilized foreign investment in GDP raised from 4.04 per cent in 2001 to 4.26 per cent in 2002, while its proportion in total fixed asset investment slightly dropped from 10.51 per cent in 2001 to 10.09 per cent in 2002. See “National Bureau
FDI in China accelerated steadily after 2004. As is shown from Figure 2 from January to December 2005, the actual use of foreign investment reached US$60.325 billion, a decrease of 0.50 per cent as compared with that of the same period in 2004. Figure 3 shows that from January to December 2006, the actual use of foreign investment reached US$69.468 billion, a decrease of 4.06 per cent as compared with that of the same period in 2005.

**Figure 2 FDI from January to December 2005**

*Source: Investment in China*

From my point of view, broadly speaking, China has made great progress in attracting foreign investment in the past few years. According to the statistics, China has approved 594,427 foreign investments in diversified forms by the end of 2006.\textsuperscript{18}

The 'open-door' policy encouraged the dramatic development of FDI in China. The growth of FDI was a key element of the Chinese economic success, not only because it had positive impacts on the economy, but also because it implied a change in the way of thinking in the political sphere. China cannot continue to develop

\textsuperscript{18} "Guide for FDI in China 2006", online: findlaw, 
<http://www.findlaw.cn/info/jingjifa/wstz/51152.html>
economically without increasing openness to the rest of the world. I believe FDI is probably the best way to encourage the pursuit of the ‘open- door’ policy and to sustain the economic performance observed since 1978 into the future.

Table 1 Investment Unitization of FDI from Jan to Dec 2006

<table>
<thead>
<tr>
<th>Country (Region)</th>
<th>Realized FDI Value</th>
<th>Up</th>
<th>Percentage in 2006</th>
<th>Percentage in 2005</th>
<th>Up or down</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>6302053</td>
<td>6032499</td>
<td>4.47</td>
<td>54.74</td>
<td>58.58</td>
</tr>
<tr>
<td>Ten Asian nations/regions</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hong Kong</td>
<td>2023292</td>
<td>1794979</td>
<td>12.73</td>
<td>22.11</td>
<td>29.75</td>
</tr>
<tr>
<td>Indonesia</td>
<td>100686</td>
<td>86757</td>
<td>16.04</td>
<td>0.16</td>
<td>0.14</td>
</tr>
<tr>
<td>Japan</td>
<td>458636</td>
<td>652877</td>
<td>-29.58</td>
<td>7.3</td>
<td>10.62</td>
</tr>
<tr>
<td>Macao</td>
<td>60290</td>
<td>60464</td>
<td>0.44</td>
<td>0.96</td>
<td>1.0</td>
</tr>
<tr>
<td>Malaysia</td>
<td>3083</td>
<td>36135</td>
<td>8.88</td>
<td>0.62</td>
<td>0.6</td>
</tr>
<tr>
<td>Philippines</td>
<td>1343</td>
<td>18890</td>
<td>-28.88</td>
<td>0.21</td>
<td>0.31</td>
</tr>
<tr>
<td>Singapore</td>
<td>226048</td>
<td>220432</td>
<td>2.55</td>
<td>3.56</td>
<td>3.65</td>
</tr>
<tr>
<td>South Korea</td>
<td>39497</td>
<td>516934</td>
<td>-24.84</td>
<td>6.18</td>
<td>8.57</td>
</tr>
<tr>
<td>Thailand</td>
<td>14482</td>
<td>9590</td>
<td>51.01</td>
<td>0.16</td>
<td>0.16</td>
</tr>
<tr>
<td>Taiwan</td>
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<td>215171</td>
<td>-0.74</td>
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<td>3.57</td>
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<tr>
<td>EU</td>
<td>532438</td>
<td>519378</td>
<td>2.51</td>
<td>8.45</td>
<td>8.81</td>
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<td>791</td>
<td>5384</td>
<td>47.03</td>
<td>0.13</td>
<td>0.09</td>
</tr>
<tr>
<td>Denmark</td>
<td>1324</td>
<td>1004</td>
<td>92.58</td>
<td>0.31</td>
<td>0.17</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>72610</td>
<td>98475</td>
<td>-24.74</td>
<td>1.15</td>
<td>1.6</td>
</tr>
<tr>
<td>Germany</td>
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<td>150004</td>
<td>3.14</td>
<td>2.54</td>
<td>0.6</td>
</tr>
<tr>
<td>France</td>
<td>38259</td>
<td>61506</td>
<td>-37.76</td>
<td>0.61</td>
<td>1.02</td>
</tr>
<tr>
<td>Ireland</td>
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<td>973</td>
<td>148.67</td>
<td>0.04</td>
<td>0.02</td>
</tr>
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<td>32201</td>
<td>8.66</td>
<td>0.56</td>
<td>0.53</td>
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<td>14200</td>
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<td>0.18</td>
<td>0.24</td>
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<td>104356</td>
<td>-19.41</td>
<td>1.33</td>
<td>1.73</td>
</tr>
<tr>
<td>Greece</td>
<td>17</td>
<td>184</td>
<td>-90.76</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Portugal</td>
<td>920</td>
<td>413</td>
<td>139.71</td>
<td>0.02</td>
<td>0.01</td>
</tr>
<tr>
<td>Spain</td>
<td>23517</td>
<td>19690</td>
<td>19.44</td>
<td>0.37</td>
<td>0.33</td>
</tr>
<tr>
<td>Austria</td>
<td>14943</td>
<td>7630</td>
<td>95.85</td>
<td>0.24</td>
<td>0.13</td>
</tr>
<tr>
<td>Finland</td>
<td>5544</td>
<td>2172</td>
<td>155.28</td>
<td>0.09</td>
<td>0.04</td>
</tr>
<tr>
<td>Sweden</td>
<td>20447</td>
<td>11145</td>
<td>82.46</td>
<td>0.19</td>
<td>0.14</td>
</tr>
<tr>
<td>North America</td>
<td>328925</td>
<td>351538</td>
<td>-6.43</td>
<td>5.27</td>
<td>5.83</td>
</tr>
<tr>
<td>Canada</td>
<td>42416</td>
<td>45413</td>
<td>-6.8</td>
<td>0.61</td>
<td>0.25</td>
</tr>
<tr>
<td>United States</td>
<td>289509</td>
<td>306123</td>
<td>-5.41</td>
<td>0.55</td>
<td>0.57</td>
</tr>
<tr>
<td>part of the free ports</td>
<td>1591329</td>
<td>132376</td>
<td>20.21</td>
<td>25.25</td>
<td>21.94</td>
</tr>
<tr>
<td>Mauritius</td>
<td>102371</td>
<td>80777</td>
<td>13.76</td>
<td>1.64</td>
<td>1.5</td>
</tr>
<tr>
<td>Cayman Islands</td>
<td>209546</td>
<td>194754</td>
<td>7.6</td>
<td>3.33</td>
<td>3.23</td>
</tr>
<tr>
<td>Virgin Island</td>
<td>1124758</td>
<td>902767</td>
<td>24.67</td>
<td>17.85</td>
<td>14.88</td>
</tr>
<tr>
<td>West Samoa</td>
<td>153754</td>
<td>138083</td>
<td>12.99</td>
<td>2.44</td>
<td>2.76</td>
</tr>
<tr>
<td>else</td>
<td>398527</td>
<td>304146</td>
<td>31.36</td>
<td>8.34</td>
<td>5.84</td>
</tr>
</tbody>
</table>

Source: Investment in China

Table 2 Utilization of Foreign Investment in China from Jan to Dec 2006

<table>
<thead>
<tr>
<th>The Mode of Utilizing Foreign Investment</th>
<th>Approved Foreign Investment This Year</th>
<th>Number of Projects</th>
<th>Realized FDI Value</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>This Year</td>
<td>The Same Period Last Year</td>
<td>Change from Previous Year</td>
</tr>
<tr>
<td>Total</td>
<td>41485</td>
<td>44019</td>
<td>-5.76</td>
</tr>
<tr>
<td>I. Foreign Direct Investment</td>
<td>41485</td>
<td>44019</td>
<td>-5.76</td>
</tr>
<tr>
<td>Equity Joint Venture</td>
<td>10223</td>
<td>10480</td>
<td>-2.45</td>
</tr>
<tr>
<td>Contractual Joint Venture</td>
<td>1036</td>
<td>1166</td>
<td>-11.15</td>
</tr>
<tr>
<td>Wholly Foreign-Owned Enterprise</td>
<td>30164</td>
<td>32308</td>
<td>-6.64</td>
</tr>
<tr>
<td>Share Company with Foreign Investment</td>
<td>60</td>
<td>47</td>
<td>6.38</td>
</tr>
<tr>
<td>Joint Exploration</td>
<td>0</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Others</td>
<td>12</td>
<td>18</td>
<td>-33.33</td>
</tr>
<tr>
<td>II. Others Foreign Investment</td>
<td>0</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Stock Issuance</td>
<td>0</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>International leasing</td>
<td>0</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Compensation Trade</td>
<td>0</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Processing &amp; Assembling</td>
<td>0</td>
<td>0</td>
<td></td>
</tr>
</tbody>
</table>

Source: Investment in China


---

19 Besides the three main forms of FDI, the “Share Company with foreign investment” was introduced by “Provisional Regulations of the Ministry of Foreign Trade and Economic Cooperation on Certain Issues Concerning the Establishment of Companies Limited by Shares with Foreign Investment” in 1995. It refers to an enterprise legal person established with the entire capital being divided into shares of equal value, where the shareholders bear responsibilities to the company to the extent of the number of the shares they hold and the company bears responsibilities for its debts with all its assets, and where the Chinese and foreign shareholders jointly hold the company's stock, with the shares subscribed and held by foreign shareholders being more than twenty-five per cent of the company's registered capital.
2.2 Foreign Trade Policy and Major Law Reforms towards FDI

Some terms that are often used when discussing FDI in China will be put in alphabetical order in Appendix IV as Glossary at the end of the thesis, with definitions.

The formal ban on FDI in China was removed in 1972, in the wake of the visit of U.S. President Richard Nixon. Removal of the ban led to a diplomatic rapprochement among China and several major industrial nations. However, severe restrictions on FDI remained in place – including a ban on external financing of FDI projects so that there was very little inbound investment until policies were dramatically changed in 1979. FDI in China was more liberally permitted in 1979, as part of the economic reform launched in December 1978. In order to accelerate economic modernization, the new policy fostered China's participation in international trade and access to external sources of capital and technology. FDI was considered as the best method of achieving the following objectives: (1) the introduction of foreign capital, and (2) the assimilation of modern technology and management skills.\(^20\)

As discussed above, Deng Xiao-Ping had consolidated power within the Chinese government and Communist Party by 1979. At his behest, the Equity Joint Venture Law providing a basic framework under which foreign firms were allowed to operate in China. Restrictions on external debt and equity finance were relaxed, and controls

\(^{20}\) "FDI and the Opening Up of China's Economy" by Françoise Lemoine, No 2000 – 11 June, CEPII, Paris, France
on foreign trade were reduced. Provincial and local governments were allowed considerable freedom in regulating joint ventures that were established within their jurisdictions.

The end of the 1970s and early 1980s also marked a period of profound reform in Chinese trade policy. During the 1970s, Chinese foreign trade was essentially monopolized by twelve state-owned trading companies, each with responsibility for a different set of commodities. Trade took place within the context of a planned economy. Therefore, all trade was subject to very exacting quantitative barriers. The state monopoly on foreign trade was ended at the end of the 1970s. What replaced the monopoly by the mid 1980s were, in essence, two separate trading regimes – one for the Foreign Investment Enterprises (hereinafter “FIEs”)\(^\text{21}\), and another for “native” Chinese enterprises.\(^\text{22}\) The trade regime under which the FIEs operated was by far the more liberal. Unlike domestic enterprises, which had to import and export through state-owned foreign trade companies, FIEs were allowed to engage in international trade directly. In addition, export-oriented FIEs were allowed to import raw materials duty-free, and also components, and capital equipment for export production. They also qualified for concessionary income tax rates and tax holidays.

As previously noted, domestic firms had to engage in international trade indirectly, obtaining imports and channeling exports through foreign trade companies

\(^{21}\) The abbreviation “FIE” here is the general word including all forms of FDI in China.

\(^{22}\) Borrowing from the Chinese terminology, Naughton (1996) refers to these two regimes as the “export processing” and “ordinary trade” regimes, respectively and he provides an excellent discussion of them.
(FTCs). To be sure, the original twelve monopolies were broken up, and by the late 1980s there were more than 5,000 FTCs operating throughout China. However, most of these FTCs were limited to trade in certain commodities, to operate in a particular province, and to serve only certain kinds of customers. Thus, domestic enterprises seeking to interact with the global economy had to work through a legally mandated, far from perfectly competitive, layer of middlemen. On top of this, most imports by domestic enterprises were not duty-free, so that domestic firms had to contend with China’s formal and informal barriers to trade. While tariffs have been reduced over the course of the 1980s and 1990s, they are still high. Moreover, some 20 per cent of Chinese imports are subject to formal non-tariff barriers.

The next major regulatory change in FDI came in 1986, with the implementation of the so-called “Twenty-two Articles.” As mentioned above, this change represented a major liberalization to encourage FDI, which applied throughout China. FIEs were made eligible for reduced business income tax rates regardless of location, and were given increased managerial autonomy. Tight controls were lifted on the remittance of profit in foreign currencies. In addition, the Twenty-two Articles designated two categories of foreign investments as being eligible for additional special benefits — “export oriented” projects (defined as projects exporting 50 per cent or more of their production value) and “technologically advanced” projects (defined as projects which upgrade domestic production capacity through the use of advanced technology).

Over time, some larger enterprises were granted independent import rights.
The Twenty-two Articles also set up an approval process for FDI projects, which remains in place today, albeit with modification. The approval process is a complex one involving thirteen agencies and branches of the central government as well as local Foreign Economic Relations and Trade Commissions. While the formal regulatory framework implies substantial centralization of power over the approval process and subsequent regulatory oversight of FIEs, there is considerable debate among China scholars as to how much the central government intervenes in the oversight of FIEs after they are established. In practice, there seems to be a considerable degree of *de facto* local autonomy in regulating FIEs.

The next major shift in FDI in China was marked not so much by a regulatory change as a change in the composition of foreign investors. FDI in China slowed briefly after the events of Tiananmen Square in 1989, but resumed and quickly grew in the 1990s.\(^\text{24}\) Whereas FDI in China in the 1980s had been overwhelmingly dominated by Hong Kong and Taiwan-based investors seeking to exploit relatively low-cost labor in the SEZs for export processing, in the 1990s FDI in China increasingly consisted of investments by Western and Japanese multinationals seeking to serve the Chinese market through local production capacity. It is also important to point out that FDI inflows in the post-1990 area were much larger than those of the

\(^{24}\) Naughton (1996), among others, suggests that there was a *de facto* loosening of the official regulations on foreign direct investment which allowed multinationals to skirt the official export requirements. Essentially, export requirements were increasingly ignored or the definition of a “technologically advanced” project was broadened to allow even not particularly technology-intensive firms to set up plants to serve the Chinese market.
1980s, both in absolute quantities and as a percentage of annual GDP. Finally, in the later 1980s and 1990s, FDI began to flow in significant quantities into the centers of China's (state-owned) heavy industry, manufacturing and finance. Of these, Shanghai and the neighboring striking, with Guangdong province, the site of three of the initial four SEZs, and neighboring Fujian, the site of the fourth, maintained dominant positions as the most important sites of FIE activity. Shanghai and the surrounding provinces have received substantial inflows starting from a low base in the late 1980s, such that it collectively became the next-largest recipient area by 1995.

China's policy towards FDI has met with remarkable success, China becoming the second-largest host country for FDI in the nineties, after the US. Several factors have contributed to this success: the gradual liberalization of China's domestic economic system has provided a more and more favorable environment for foreign firms' activity; and the high rate of economic growth achieved over twenty years has created a rapidly expanding domestic market which has attracted foreign investors. Lastly, China's integration into the world economy has been accelerated by the trend towards globalization, which meant a steady and rapid expansion of global FDI since 1992.25

Generally speaking, China’s policies toward FDI have experienced roughly three stages: gradual and limited opening, active promoting through preferential treatment, and promoting FDI in accordance with domestic industrial objectives. These changes in policy priorities inevitably affected the pattern of FDI inflow in China.

In order to create a favorable investment environment and to encourage overseas firms to invest in China, since 1979, the Chinese government has gradually set up a relatively complete legal system, and constituted a foreign investment policy system, which mainly includes industrial policies, regional policies, tax policies and financial polices.

Since 1978 significant legal changes have been made to serve the country’s economic development, including a series of constitutional revisions. For example, the 1982 Constitution for the first time acknowledged non-public ownership activities as a necessary and beneficial complement to the socialist economy. In 1993, the revised Constitution recognized the market economy as the main economic mode at the socialist ‘preliminary stage’. In the 1999 Constitution, non-public ownerships were established as ‘important components of the socialist market economy’, and for the first time the Constitution guaranteed that ‘the People’s Republic of China shall be governed according to law and shall be built into a socialist country based on the rule of law. It is expected these Constitutional revisions will have a significant impact in the future. Consistent with constitutional revisions, major economic laws such as the Economic Contract Law and the Foreign Investment Law have also been created.\(^{26}\)

\(^{26}\) Take intellectual property laws as an example. There were 4044 registered trademarks in
Through a series of laws passed in the 1980s, China sought to regulate in great detail trade in goods between Chinese and foreign business enterprises. These laws governed such things as the licensing of imports and exports, commodity inspection, and the content of import-export contracts. Chief among them is the so-called Foreign Economic Contract Law (FECL) of 1985. In 1994 the NPC enacted a comprehensive Foreign Trade Law, which seeks to unify all the enactments concerning the organization and administration of foreign trade into a coherent whole. I summarize the main laws and regulations for FDI in China in table 3 as follows.

China prior to 1961, more than half of which (2035) were foreign-owned trademarks. The trademark registration and protection system was destroyed during the Cultural Revolution period, and finally resumed after the 1978 reforms. In 1982, the Trademark Law was promulgated and the Detailed Rules for the Implementation of the Trademark Law was published in 1988 (both were amended in the 1990s).
Table 3 Main Laws and Regulations for FDI in China

<table>
<thead>
<tr>
<th>General Laws and Regulations</th>
<th>Special Laws and Regulations</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Company Law of the People's Republic of China</td>
<td>The law of P.R.C. on Chinese-Foreign Equity Joint Ventures and its implementation regulations</td>
</tr>
<tr>
<td>The Contract Law of the People's Republic of China</td>
<td>The law of P.R.C. on Chinese-Foreign Contractual Joint Ventures and its implementation regulations</td>
</tr>
<tr>
<td>The Insurance Law of the People's Republic of China</td>
<td>The law of P.R.C. on Wholly Foreign-Owned Enterprise and its implementation regulations</td>
</tr>
<tr>
<td>The Arbitration Law of the People's Republic of China</td>
<td>The law of P.R.C. on Foreign-invested enterprises, the income tax and its implementation regulations</td>
</tr>
<tr>
<td>The Labor Law of the People's Republic of China</td>
<td>Provisions on Guiding Foreign Investment Direction; Industrial Catalogue for Foreign Investment; Catalogue of Advantageous Sectors for Foreign Investment in Central and Western Regions</td>
</tr>
<tr>
<td>Provisional Regulations of the People's Republic of China on value-added Tax</td>
<td></td>
</tr>
<tr>
<td>Provisional Regulations of the People's Republic of China on Consumption Tax</td>
<td></td>
</tr>
<tr>
<td>Provisional Regulations of the People's Republic of China on Business Tax</td>
<td></td>
</tr>
</tbody>
</table>
From my point of view, China has made great strides in its reforms to open up its market for FDI. Among developing countries, China is now the largest recipient of foreign capital. FIEs have played an increasingly important role in Chinese economic reform. It is also a large part of China’s trading activities with the rest of the world. While there may be some differences of interpretation with respect to the role of FDI in raising China’s GDP, no doubt without FDI China’s economy will not develop so quickly. China’s decisions to join the WTO and to establish free trade zones in Asia at the beginning of the new century are important examples of its gradual integration and its political strategy. I believe the entry of China into the WTO provides another impetus for internal reforms and China’s global economic involvement.
Chapter 3 Tax Policy and Incentives for FDI

Chapter 2 provided a general overview of FDI in China. Chapter 3 describes China’s tax system and policy-orientation in detail, focusing on the tax incentive policy towards FDI in China. Moreover, because it is better to learn from the experience of other developed nations concerned about the FDI tax incentive, Chapter 3 contains an international comparison and reference on tax incentive policy elsewhere.

3.1: Overview of China’s Tax System and Legislations

3.1.1. China’s Tax System

Under the current tax system in China, there are 22 taxes which can be divided into four categories according to their subject-matter.  


See Table 4 in the next page.
Table 4 Taxes in China

<table>
<thead>
<tr>
<th>Category</th>
<th>Taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxes on goods and services</td>
<td>VAT</td>
</tr>
<tr>
<td></td>
<td>Consumption Tax</td>
</tr>
<tr>
<td></td>
<td>Vehicle Acquisition Tax</td>
</tr>
<tr>
<td></td>
<td>Business Tax</td>
</tr>
<tr>
<td></td>
<td>Customs Duty</td>
</tr>
<tr>
<td>Income taxes</td>
<td>Enterprise Income Tax</td>
</tr>
<tr>
<td></td>
<td>Income Tax on Enterprises with</td>
</tr>
<tr>
<td></td>
<td>Foreign Investment and Foreign Enterprises</td>
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<tr>
<td></td>
<td>Individual Income Tax</td>
</tr>
<tr>
<td></td>
<td>Land Appreciation Tax</td>
</tr>
<tr>
<td>Property taxes</td>
<td>House Property Tax</td>
</tr>
<tr>
<td></td>
<td>Urban Real Estate Tax</td>
</tr>
<tr>
<td></td>
<td>Urban and Township Land Use Tax</td>
</tr>
<tr>
<td></td>
<td>Farmland Occupation Tax</td>
</tr>
<tr>
<td></td>
<td>Deed Tax</td>
</tr>
<tr>
<td></td>
<td>Resource Tax</td>
</tr>
<tr>
<td></td>
<td>Vehicle and Vessel Usage Tax</td>
</tr>
<tr>
<td></td>
<td>Vehicle and Vessel Usage License Plate Tax</td>
</tr>
<tr>
<td></td>
<td>Vessel Tonnage Tax</td>
</tr>
<tr>
<td>Other taxes</td>
<td>Stamp Tax</td>
</tr>
<tr>
<td></td>
<td>City Maintenance and Construction Tax</td>
</tr>
<tr>
<td></td>
<td>Tobacco Tax</td>
</tr>
</tbody>
</table>

The total tax revenue collected by the Tax Administration, the Finance Department and the Customs Administration in 2004 was 2416.57 billion Yuan (about 300 billion USD), which accounted for 91.5 per cent of China’s total fiscal revenue and 15.1 per cent of GDP in 2004.28

28 <China Foreign Tax Guide>P211 published by LAW Press China
3.1.2. China’s Current Tax Legislative Regime

In tax legislation and policy formulation, China centralizes power and seeks uniformity. The tax system is complicated by the number of governmental agencies involved in making rules, including not only the National People’s Congress (hereinafter “NPC”) but also other departments and organs such as the NPC Standing Committee, the State Council, the Ministry of Finance, the State Administration of Taxation (hereinafter “SAT”), the General Administration of Customs and the Tariff and Classification Committee of the State Council.29

The tax system is based ultimately on the laws formulated by the NPC,30 or by the Standing Committee of the NPC.31

Administrative regulations and rules are formulated by the State Council in accordance with relevant tax laws, or under the authorization of the NPC and its standing committee.

Departmental rules are formulated by the Ministry of Finance, the State Administration of Taxation, the General Administration of Customs and Tariff and Classification Committee of the State Council, pursuant to the relevant laws and regulations.

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30 For example, Corporate income Tax Law of PRC
31 For example, The tax collection and administration law of the PRC
In addition, according to national laws, the People's Congress and its standing committee of provinces, autonomous regions, municipality cities\(^\text{32}\) and some large cities may formulate some local tax regulations and rules so long as they do not contradict national laws and regulations. However, the Central Government will not levy any tax in the special administrative regions, which comprise Hong Kong and Macao. The figure 4 shows the tax legislative organ of PRC.

**Figure 4 Tax legislative organ of PRC**

\(^{32}\) "Municipality city" means direct-controlled municipalities (by the central government) which are the highest-level cities in China, with status equal to that of the provinces. Current municipalities of PRC are Beijing, Tianjin, Shanghai, and Chongqing,
3.1.3. Tax Legislation Applicable to FDI

Although there used to be as many as 22 taxes under the tax system in China, only 14 of them are applicable to the FDI according to the regulations of the NPC and its Standing Committee and the State Council of China.

3.2: Tax Preference Policy and Incentives for FDI

3.2.1. Tax Preference Policy Reforms for FDI

Since China opened its doors to foreign investors in 1979, tax incentives have been used extensively to attract FDI into different geographical regions of the country. Preferential tax rates and other incentives are important determinants of regional investment decisions in China. Regions offering lower tax rates and increased tax incentives attract greater amounts of FDI.

In a developed or developing country, a good tax system favorably affects the whole economy. For the PRC, the Open Door policy marked the beginning of economic reform.33 In anticipation of an influx of foreign investment resulting from this policy shift, Chinese legislators promulgated the first legislation concerning taxation of FIEs in 1980---JV Tax Law.34

33 By the end of May 2001, more than 370,000 FIEs had been approved, among which 250,000 started operations. The actual foreign investment has amounted to over US$370 billion. The introduction of foreign capital and technology has greatly promoted the development of China’s National economy.
34 The Income Tax Law of the PRC Concerning Sino-Foreign Joint Ventures (the “JV Tax Law”), adopted at the 3rd Session of the 5th National People’s Congress, promulgated on September 10, 1980 and revised on Sept 2nd 1983. The implementing rules were promulgated by the Ministry of Finance on Dec 14th, 1980.
However, the JV was only one type of foreign enterprise, and to deal with other types of foreign entities, legislators introduced the Income Tax Law of the PRC Concerning Foreign Enterprises (the Foreign Enterprises Tax Law)\textsuperscript{35} on Dec 13\textsuperscript{th}, 1981. The JV Tax Law governed all the FIEs, including Sino-foreign equity joint ventures (EJVs), Sino-foreign cooperative joint ventures (CJVs) and wholly foreign-owned enterprises (WFOEs), while the Foreign Enterprises Tax Law governed the taxation of general foreign enterprises.

Since its inception, the foreign-related tax system remained a separate structure from the domestic tax system. The separate tax system for foreigners basically catered to the current needs of China's reform and economic development, and played an important role in mobilizing revenue, attracting foreign capital, bringing in advanced technology, expanding international trade and safeguarding economic rights and interests. Following the establishment of the target of building a socialist market economy, however, the separate foreign-related tax system no longer met the needs of economic restructuring and development. So, the introduction of a unified tax system became essential.\textsuperscript{36}

In 1991, a new tax law was introduced which superseded the two previous income tax laws. This new law provides additional tax benefits, which improve the

\textsuperscript{35} Income Tax Law of the PRC Concerning Foreign Enterprises, approved at the 4\textsuperscript{th} Session of the 5\textsuperscript{th} National People's Congress on Dec 13\textsuperscript{th}, 1981. The implementing rules were promulgated by the Ministry of Finance on Jan 1\textsuperscript{st} 1982.

\textsuperscript{36} This was the first unified reform which occurred in 1990's. In 2007, China promulgated the unified enterprises income tax law which governs all the enterprises in China. This will be discussed in Chapter V, so called second uniform.
investment environment for foreign investors. In April 1991, the Fourth Session of the Seventh National People's Congress adopted the Income Tax Law of the People's Republic of China on Foreign-Funded Enterprises and Foreign Enterprises (FEITs Law), which established a unified income tax system, abolishing and replacing the JV Tax Law and the FEITs Law. With the exception of China-sourced income unrelated to investment or permanent establishment, the FEITs Law introduced a single income tax rate—30 per cent national plus 3 per cent local, which could be exempted or reduced depending on the location of the project and the industry involved, and abolishing differential rates that formerly depended on the legal form of the different investment entities. The results of the tax effect on FDI became very apparent in the post-1991 period.

The new tax law eliminated many disparities in the taxation of different types of foreign entities, but perpetuated the deliberate policy discrepancies between the taxation of foreign-funded and domestic enterprises. Some of the resulting problems included the following:

(1) Regional discrepancies at multiple levels in existing preferential tax policies hamper foreign investment in the development of border, remote and poor regions. At the same time, such discrepancies also foster harmful competition among local

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37 PRC Foreign-Invested Enterprises and Foreign Enterprises Income Tax Law, adopted by the National People's Congress on April 9, 1991. The detailed rules related to the law were promulgated on June 30, 1991.

38 <Foreign-Related Tax Policy and Development of the Tax System> by Cheng Faguang, Deputy Director of the State Administration of Taxation in "Beijing Review", 42(1999), n. 4
governments trying to attract foreign investment by formulating preferential policies, leading to unnecessary losses of tax revenue for the State.

(2) Current preferential policies favoring certain industries conflict with national industrial policies. These conflicting policies are mainly geared to production enterprises. However, tax regulations cannot list all manufacturing industries when defining production enterprises. They only generally categorize enterprises into several major industries. Judging from the national industrial policy, some "productive" enterprises are not included in the category encouraged by the State, while some others, traditionally defined as "non-productive", are on the list encouraged by the State under the present industrial policy.

(3) Complicated tax incentives bring about difficulties in implementation, add complexity to the tax laws and regulations, and allow some taxpayers opportunities to take advantage of policy loopholes.

3.2.2. Tax Incentives toward FDI in China (before January 1st, 2008)

Many developing countries offer income tax incentives to attract foreign investment. These countries have introduced investment incentives for varying

39 From January 1st 2008, a new unified enterprise income tax law will impose a general tax rate at 25per cent for all companies domestic or foreign, which means the existing incentives will be stopped. However, foreign investors have a maximum 5 year grand-fathered period which means from 2008 to 2012, the tax incentives will still be applied to some foreign investors.

40 Using the tax system to influence economic behavior by granting tax incentives for particular activities has developed an enormous literature following the lead of Professor Stanley Surrey, who noted the equivalence of such incentives to direct expenditure programs and coined the term “tax expenditures” to refer to them.

See Stanley Surrey, Pathways to Tax Reform (1973); International Aspects of Tax
reasons. In some cases, especially in transition countries that have not reformed the socialist tax system, the incentives may be seen as a counterweight to the investment disincentives inherent in the general tax system.

In other countries, the incentives are intended to offset other disadvantages that investors may face, such as a lack of infrastructure, complicated and antiquated laws, and bureaucratic complexities and weak administration, in the tax area or elsewhere. If these are the reasons, the appropriate solution is to reform the existing laws that create the problems and to build the necessary administrative capacities and infrastructure. This solution is often impractical and unrealistic ("easier said than done"), with recourse of extra special tax incentives as a form of temporary relief ("quick fix") until more fundamental reforms can be completed. Countries sometimes introduce incentives to keep up with other countries in competing for international investment. More rarely, tax incentives are introduced after deficiencies in law and administration are remedied, and are directed to areas of economic activity that the country wishes to develop. Although standard international tax policy advice cautions against the use of tax incentives for investment, many developing and transition countries, as well as many industrial countries continue to offer or introduce them.


The Chinese concept of “Tax Preference” includes reduced tax rates, tax exemptions, reductions, investment refunds, accelerated depreciation, carry-over loss and other measure. \(^{42}\) In foreign investment policy, preferences have been differentiated according to investment forms, geographic location, industry classification and even ethnic background of the foreign investment.

Basically, the general tax rate for FIEs is 30 per cent national and 3 per cent local. However, under certain local tax rules, a full exemption can be granted from the local tax by the local authority\(^ {43}\) but it could not grant any reduction or exemption of the national tax rate. The laws provide for national rate reductions to 24 or 15 per cent depending on the location and the nature of the project.\(^ {44}\) In order to attract foreign investment, the Chinese government has introduced a range of tax incentives to FIEs in the following respects.

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\(^{42}\) Other preferences include tax credits, tax sparing, and installment tax payments.

\(^{43}\) FEIT Law Art 9

\(^{44}\) Id., Art 7
3.2.2.1 Table 5 Preferential Tax Rate

<table>
<thead>
<tr>
<th>Tax rate</th>
<th>FIEs</th>
</tr>
</thead>
</table>
| Enterprises in the following regions (sectors) are subject to corporate income tax at the halved rate of 15 per cent. | 1. FIEs in the Shenzhen, Zhuhai, Shantou, Xiamen and Hainan SEZs\(^{46}\)  
2. Foreign enterprises with establishments or venues in special economic zones and engaged in production and business operations  
3. Production FIEs established in economic and technological development zones approved by the State Council and in the Pudong New Area in Shanghai  
4. Technology- and other knowledge-intensive projects launched by FIEs in old urban districts of SEZs, economic and technological development zones and coastal economic open areas approved by the State Council, with long investment recovery periods and foreign investment exceeding US$30 million\(^{47}\)  
5. Production FIEs engaged in energy, transportation and port-construction projects; Production FIEs engaged in export processing in bonded areas  
6. Recognized high-tech FIEs in new- and high-technology IDZs at state-level approved by the State Council |
| Production FIEs in the following regions are subject to corporate income tax at reduced rate of 24 per cent \(^{48}\) | 1. Production FIEs in old urban districts of coastal economic open areas, special economic zones, and economic and technological development zones to which the 15 per cent preferential tax rate is not applicable \(^{49}\)  
2. Open coastal cities, open cities along the Yangtze River and in inland and border regions, as well as other areas designated by the State Council as eligible for the same concessions; and State tourist resorts |

\(^{45}\) Ibid.  
\(^{46}\) FEIT Rules Art 69  
\(^{47}\) FEIT Rules Art 73  
\(^{48}\) FEIT Law Art 7  
\(^{49}\) FEIT Rules Art 71
3.2.2.2 Exemption and Reduction of Income Tax

Production FIEs with an operating period of over 10 years (excluding projects for the exploration of petroleum, natural gas, rare metals and precious metals) are eligible for corporate income tax exemption in the first two profit-making years and for reduction by half in the following three years (the “two-plus-three rule”). With the approval of SAT, FIEs engaged in agriculture, forestry and animal husbandry and FIEs established in the economically-backward remote and border areas may be levied corporate income tax at the reduced rate of 15 per cent to 30 per cent for an additional 10 years after the expiration of the two-plus-three rule period of five years.\(^{50}\)

(1) Sino-foreign joint ventures engaged in port and wharf construction and with an operating period of over 15 years are eligible for corporate income tax exemption in the first five profit-making years and for reduction by half in the following five years (“five plus-five rule”)\(^{50}\)

(2) Infrastructure projects related to airports, ports, wharfs, railways, highways, power stations, coal mines and water conservancy facilities as well as agricultural development in the Hainan SEZ with an operating period of over 15 years are eligible for corporate income tax exemption in the first five years and reduction by half in the following five years.

(3) Infrastructure projects related to airports, ports, railways, highways and power stations in the Pudong New Area in Shanghai with an operating period of over

\(^{50}\) FEIT Law Art 8
15 years are eligible for corporate income tax exemption in the first five years and for
reduction by half in the following five years.

(4) The following types of enterprises are eligible for corporate income tax exemption in the first profit-making year, and for reduction by half in the second and third years, with the approval of the local tax authorities: FIEs engaged in services in SEZs with foreign investment exceeding US$5 million and with an operating period of over 10 years; Foreign-invested banks, Chinese-Foreign banks and other financial institutions in special economic zones and other areas designated by the State Council with foreign capital investment exceeding US$10 million and with an operating period of over 10 years.

(5) Approved high-tech Sino-foreign joint venture enterprises in state-level high-technology development zones with an operating period of over 10 years are exempt from corporate income tax in their first two profit-making years.

(6) Foreign-invested export-oriented enterprises pay income tax at the reduced rate of 15 per cent or 10 per cent following the expiration of the corporate income tax exemption and reduction by half concession if their export value amounts to over 70 per cent of their total output value in the current year.

(7) Foreign-invested high-tech enterprises pay corporate income tax at the reduced rate of 15 per cent or 10 per cent for three years following the expiration of the corporate income tax exemption and reduction by half concession, if their status as high-tech enterprises remains unchanged.  

51 FEIT Rules Art 74, 75, and 76
3.2.2.3 Tax Refund on Re-investment by FIEs\textsuperscript{52}

Any foreign investor in an FIE re-investing its profit obtained from the enterprise directly into that enterprise or to establish other FIEs with an operating period of at least five years is, upon approval granted by the competent tax authorities, eligible for a 40\% refund of the corporate income tax already paid on the re-invested amount. If the foreign investor re-invests its profit directly in establishing or expanding an export-oriented or high-tech enterprise in China, the corporate income tax already paid on the re-invested amount is fully refunded.

3.2.2.4 Other Exemptions and Reductions of Income Tax\textsuperscript{53}

Besides, there are some exemptions and reductions regarding other aspects according to the FEITs law and its rules as follows.

(1) The profits of foreign investors derived from FIEs are exempt from income tax.

(2) The interest revenue of international financial institutions derived from loans to the Chinese government or state banks and the interest revenue of foreign banks derived from loans to Chinese state banks at preferential rates are exempt from income tax.

(3) Royalties paid to foreign enterprises for their provision of special technologies to China for scientific research, exploitation of energy resources, development of transportation, production from agriculture, forestry and animal

\textsuperscript{52} FEIT Law Art 10 FEIT Rules Art 80, and 81.

\textsuperscript{53} FEIT Law Art 19
husbandry, and development of important technologies, is eligible for income tax at
the reduced rate of 10 per cent, with the approval of SAT. Enterprises that involve
advanced technologies or offer favorable terms, receive income tax exemption.

(4) In the case of FIEs or foreign enterprises with establishments or venues
engaged in production or business operations within the territory of China, 40 per cent
of their investment in the purchase of domestically-produced equipment can be offset
against the incremental corporate income tax of the prior year.

(5) With the approval of the tax authorities, FIEs that have increased their
technological development expenses by more than 10 per cent over the previous year
are allowed to offset their taxable income in the current year by 50 per cent of the
amount of technological development expenses.\(^{54}\)

(6) The governments of various provinces, autonomous regions and
municipalities have also introduced local income tax exemptions or reductions for
those sectors or projects where foreign investment is encouraged.

In summary, foreign enterprises receive many tax incentives on income. The
main purpose of setting up these rules is to attract foreign investment to China.
However, problems arise from the special treatment to foreign investors.

3.3. International Comparison and Reference on Tax Preference Policy

In practice, many counties use flexible methods to carry forward tax incentives
gradually. Combinations of tax incentives work better than application of a single
incentive. Normally, there are two ways of combining incentives. One type of
\(^{54}\) The details are contained in SAT’s Procedures for the Administration of Pre-Tax
Deductions of Enterprise Technological Development Expenses.
incentive is called "direct incentives," which include "tax exemption" and "preferential tax rate". The other combination, called "indirect incentives" include "accelerated depreciation"\textsuperscript{55}, "investment refunds" and "carry-over loss".

The most popular incentive is the tax exemption period, which means there is no income tax on the profits made during a certain period of time. An investigation of 32 developing countries revealed they all have this kind of exemption. The length of a tax exemption period varies among different counties. Usually, it is influenced by the amount of investment, locations, numbers of employees, etc. For instance, Tunis has a twenty-year exemption period and sometimes even longer. Some counties like Thailand and Korea have reduced rates, which could be 50 per cent. In terms of the preferential tax rates, for instance, Vietnam has three levels: the regular rate ranges from 21 per cent to 25 per cent; technological investment can enjoy a 15 per cent- to-20 per cent tax rate and investing on farm developing can have 10 per cent to 14 per cent preferential rate. The "direct incentives" focus on the real tax exemption, which

\textsuperscript{55} Accelerated depreciation refers to several methods by which a company, for 'financial accounting' and/or tax purposes, depreciates a fixed asset in such a way that the amount of depreciation taken each year is higher during the earlier years of an asset's life. For financial accounting purposes, accelerated depreciation is generally used when an asset is expected to be much more productive during its early years, so that depreciation expense will more accurately represent how much of an asset's usefulness is being used up each year. For tax purposes, accelerated depreciation provides a way of deferring corporate income taxes by reducing taxable income in current years, in exchange for increased taxable income in future years.
may be abused to undertake tax-evasion.\textsuperscript{56} However, the indirect part focuses on the tax installment during a certain period of time which encourages competition among investors, and could guarantee the governmental revenue. For instance, the investment refunds require the investors to qualify for refunds on the basis of a certain amount of investing, which, to some extent, guarantees the amount of investing and minimizes the risk of the host country. Overall, because the "indirect incentives" are more useful and feasible, they are recommended by most developed countries, and recently developing countries also realize the advantage of the "indirect incentives," with the result that they are becoming popular.


Tax treaties represent an important aspect of the international tax rules of most counties. More than 2000 bilateral income tax treaties are currently in effect. China has 83 bilateral income tax treaties (Appendix I) currently, and the number will increase in the future. For an FDI investor's benefit, I think it is better to know the income tax treaties between the host country and the investing country because bilateral treaties may provide tax preferences for nationals of the two signatory counties. I will provide some basic information below with a general view of treaties.

\textsuperscript{56} Investors enjoy the real exemption by paying less tax which is good for the investors but not quite good for the counties suffer revenue loss.
3.4.1. OECD Tax Treaty Provision Model

Treaties are agreements between sovereign states.\textsuperscript{57} The relationship between tax treaties and domestic tax legislation is a complex one in many counties. The objective of tax treaties is to facilitate cross-border trade and investment by eliminating the tax impediments to these cross-border flows. The most important operational objective of bilateral tax treaties is the elimination of double taxation.

As each country has the power to design its own tax system, businesses that operate in two or more countries may find that the different tax systems increase their liability for taxes, thus constituting a disincentive to international trade and investment. In an attempt to overcome such disincentives, OECD countries have developed networks of tax treaties with other countries, designed to prevent ‘double taxation’ of the same tax base by more than one country. To some extent, these treaties have also addressed the less common issue of ‘gaps in taxation’, whereby income is not taxed by either jurisdiction. These tax treaties are generally based on the ‘OECD Model Tax Convention’, and enshrine the principle of residence-based taxation.\textsuperscript{58} That is, they are based on the idea that income taxes on world-wide income should be paid in the country of residence, as this is the country that typically provides public services to the taxpayer. Nonetheless, these treaties do generally

\textsuperscript{57} Article 2 of the Vienna Convention on the law of Treaties provides: A treaty is an international agreement (in one or more instruments, whatever called) concluded between states and governed by international law.

\textsuperscript{58} See Christopher Heady “Tax policy in developing countries: what can be learned from OECD experience?” P12-13
allow for significant taxation by the ‘source country’, the country in which the income was earned. Thus an overseas subsidiary will pay corporate tax and withholding taxes in the country where it operates, while its parent company will be able to claim a credit for this tax when it pays tax in its country of residence on its world-wide income.\textsuperscript{59} These tax treaties are regarded as a major method of reducing the tax impediments to both international trade and investment.

OECD countries have found that their treaties have encouraged large-scale international trade and investment. Developing countries may well find that they will be able to attract more foreign investment if they enter into tax treaties with the countries from which such investment might derive. Such treaties may well protect a country’s tax base, and reassure potential investors that they will not be subject to double taxation.

It has been argued that the OECD model places too much emphasis on residence taxation, especially by the limits that are typically placed on withholding taxes and the widespread denial of tax sparing.\textsuperscript{60} This could hurt developing countries because they are much more likely to be the source country than the residence country of a multi-national group. The significance of this criticism is hard to judge, but it is worth

\textsuperscript{59} Alternatively, some countries do not tax the parent company on its world-wide income if that income was already taxed in the source country.

\textsuperscript{60} Tax sparing occurs when the source country provides a tax relief and the residence country allows a foreign tax credit for the tax that would have been payable if the tax relief had not been applied. The denial of tax sparing effectively removes a large part of the incentive value of tax relieves offered to attract foreign direct investment.
pointing out that the rates of withholding taxes are negotiable between treaty partners. In addition, a large number of developing countries offer significant tax concessions to foreign investors, suggesting that they are willing to sacrifice potential tax revenues in order to attract foreign investment.

### 3.4.2. Special Tax Incentives in OECD Models

All OECD countries, and probably most countries in the world, have special provisions in their personal and corporate income tax systems to favor particular groups of the population or provide incentives for particular types of behavior. These can be motivated by a combination of political, economic and social considerations. Once established, such tax concessions can be difficult to remove even though their original justifications no longer apply. There are, typically, a growing number of such concessions and their costs, in terms of forgone revenue, continue to grow. It was recognition of the costs of these concessions that led to their partial removal as part of the trend towards lower tax rates and broader tax bases.

However, some tax concessions have not been removed. For example, at the corporate level, many OECD countries provide tax relief to small firms and to firms that invest in research and development. An exhaustive list of all examples of tax reliefs in OECD countries would fill a small book.

The desirability of many of these reliefs is the subject of debate, between those who either benefit from them or who value the activity that is encouraged and those who think that the forgone revenue would be better spent by a further lowering of the statutory tax rates. It is hard to provide general lessons for developing countries in this
area, except to recommend caution: relief is much harder to remove than to introduce. Nonetheless, there is an area of tax incentives that has caused controversy and is particularly relevant to developing countries: the idea that company taxation should be designed to provide incentives for inbound FDI. Such FDI, it is argued, could contribute to the increase in productivity by introducing modern machinery and providing skills to a poorly trained workforce.

The issues here are complex and cannot be discussed in full in the confines of the thesis, but an outline of the relevant considerations can be sketched. A more detailed analysis of the case for granting tax incentives to FDI, and the advantages and disadvantages of alternative incentive mechanisms, can be found in OECD (2003).

I think the first point to bear in mind is that taxation is only one of the factors that multinational firms take into account in deciding where to invest. What is more, as many of the tax incentives relate to corporate income tax, taxation only becomes an issue if other factors are sufficiently positive for the firm to expect the project to be profitable. As a result of this complex of considerations, it has often been argued that tax incentives for FDI are relatively ineffective. However, recent evidence suggests that tax incentives can have a noticeable effect on the location of investment, especially between locations that are similar in other respects.

There is growing support, therefore, for the idea that tax incentives can be effective in attracting FDI. However, there is also recognition of the fact that

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61 "Checklist for Foreign Direct Investment Incentive Policies", online: OECD,
neighboring countries, which may often offer similar non-tax attractions, could compete against each other in offering tax incentives in a way that provides a benefit to the investor without increasing the total amount of FDI allocated to the region. This risk has been taken so seriously in the European Union (EU), that it has developed a ‘code of conduct’, which *inter alia* forbids EU countries offering tax concessions to foreign-owned firms that are not available to domestic firms.\(^6\)

Despite the risks of losing substantial revenues and provoking a competitive response from neighbors, many countries do offer tax incentives to attract FDI in such forms as tax holidays, accelerated depreciation or investment tax credits. I want to point the question that countries have to answer is whether the additional investment created by such incentives is really worth the revenue forgone from investments that would have been made without the incentives.\(^6\) This is often very difficult to judge, and the answers are likely to vary from country to country.

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\(^6\) This competition for real investment should be distinguished from competition for mobile services, which typically require little investment apart from a ‘brass plate’ and provide very limited benefits to the local economy. The issues involved in the latter case are discussed in OECD (1998) and form the basis of the OECD’s work on ‘harmful tax practices’. “Harmful tax competition—An Emerging Global Issue”, online: *OECD*, [http://www.oecd.org/dataoecd/33/0/1904176.pdf](http://www.oecd.org/dataoecd/33/0/1904176.pdf)

\(^6\) An additional problem that can arise, if the FDI incentives are subject to administrative discretion, is the increased opportunities for the corruption of public officials.
Chapter 4 Tax Issues regarding FDI in China

China faces the challenge of designing and carrying out reform of its tax system following its transformation from a centrally-planned to a market economy. Among the various incentives to draw FDI into China, tax incentives are probably the most attractive for foreign investors. China’s FDI policies and tax incentives have been significant influences on its growth, its regional distribution within China, and the influx of technology.

However, the policies and incentives raise some issues. As the result of offering FDI tax preference, Chinese government tax revenue as a percentage of GDP has been declining steadily. In some areas, local governments collect fees without fair rules, which easily led to corruption. Some of the planning around FDI involves tax avoidance and even goes to extreme of the tax evasion. Experts believe that tax evasion is a possible cause for the lack of growth in tax collections.\textsuperscript{64} Since FDI receives incentives that are unavailable to domestic enterprises, they may set up “fake” FDI entities to enjoy them. Although tax reform has made progress in creating tax equity and fair competition, problems remain to be solved in the future. Chapter 4 also contains a discussion of some international tax issues that China is facing.

4.1. Current Tax Avoidance

International transactions offer opportunities for tax avoidance. The term “tax avoidance” must be distinguished from tax evasion, which is illegal and usually involves either fraud or the intentional nondisclosure of income. Tax avoidance means

\textsuperscript{64} Officials from the State Administration of Taxation reveal China's tax revenue annually suffers a loss of 30 billion yuan (US$ 3.88 billion) due to multinational corporations' evasion of tax. online: xinhuanet,

transactions or arrangements entered into by a taxpayer in a lawful fashion in order to minimize the amount of tax payable.\textsuperscript{65} Tax avoidance has become a serious problem facing most countries, and China is no exception. Different forms of tax incentives can be used by enterprises to take unfair advantage of the policies and regulations. Although reasonable tax avoidance is allowed to some extent, some taxpayers abuse the leeway offered to them. It is incredible that a top-500 company seems to suffer operating losses every year while expanding the business at the same time. China has provided tax incentives to attract foreign investment, with consequential loss of tax collection due to those incentives, along with tax avoidance and tax evasion.

For example, it was reported that China has suffered a 30 billion yuan (about US$3.88 billion loss of tax revenue from tax avoidance by Multinational Companies (hereinafter "MNCs") ----however, officials from the SAT reveal that the fact is China's tax revenue suffers an annual loss of 30 billion yuan.\textsuperscript{66} Normally, there are two methods for avoiding tax; first, MNCs import raw materials at a high price but export products at a low rate (called "transfer pricing") (hereinafter "TP"). Second, MNCs take advantage of the differences in financial settlement and accounting systems of countries and regions, transferring their revenue from high tax areas to lower taxed ones (called "tax havens").\textsuperscript{67}

\textsuperscript{65} See Brian J.Arnold and Michael J.McIntyre \textit{International Tax Primer}, Chinese version P131-132
\textsuperscript{66} Some experts say that the expression MNCs" tax evasion totaling 30 billion yuan" is not quite correct. These experts assert that the conclusion should be "China's tax revenue annually suffers a loss of 30 billion yuan due to tax avoidance by MNCs".
How could those MNCs be achieving such tax avoidance? Three common methods that are widely used to avoid tax include: (1) TP; (2) tax havens; and (3) thin capitalization.

4.1.1. Transfer Pricing (TP)

4.1.1.1. Definitions

A transfer price is a price set by a taxpayer when selling to, buying from, or sharing with, a related person. For example, if the taxpayer, A Company manufactures goods in China and sells them to its foreign affiliate, B Company set up in B country, the price at which the sale take place is called a transfer price. A transfer price is usually contrasted with a market price, which is the price in the marketplace for such transfers between unrelated persons. MNCs use transfer prices for sales and other transfers of goods and services within their corporate groups. Unless regulations prevent them from doing so, related persons engaging in cross-border transactions can avoid the income taxes of a host country through their manipulation of transfer prices.

MNCs residing in one state and doing business in third-party states take advantage of TP to increase profit by enjoying preferential taxation in nonresident countries (tax havens) resulting in the tax escaping from the country of residence.

MNCs transfer profit out of China to avoid tax by means of TP. Though MNCs earned profits overall, they reported losses in China. Among the others, it is

68 See Brian J. Arnold and Michael J. McIntyre, <International Tax Primer>, P87-89

69 See Transfer Pricing Tax System and Its Development in China by State Administration of Taxation of PRC.

70 Statistics show that between 1988 and 1993, 35-40 per cent of FIEs reported losses. Between 1994 and 1995, 50 per cent to 60 per cent reported loss. Between 1996 and 2000, 60 per cent to 70 per cent reported losses. It was true that some FIEs did lose money. Most others
recognized that TP was the preferred method for avoiding tax.\textsuperscript{71} While the details might differ from case to case, a typical scenario would involve a related party outside China in control of purchase and delivery. The associated party in China would import items such as equipment, raw material, spare parts, service and intangible assets at a price higher than the market price and export its products or services at a price conspicuously lower than the market price.

4.1.1.2. Related Legislation

Many factors may influence MNCs' manipulation of TP, which include taxation, tariffs, business risks and relevant transaction costs. With the avoiding of double taxation as an impediment to world trade, TP become a more complicated issue of international tax law. As many MNCs became established in China, detailed TP regulations were issued in 1998, China being the second country in Asia (after Japan) to regulate TP.\textsuperscript{72}

The regulation contains both the procedural and substantive aspects of TP investigations in China. Generally the regulations allow the tax bureau to make adjustments to tax payable on companies who do not conduct transactions as independent enterprises, resulting in any reduction of taxable income.

\textsuperscript{71} Other methods used by foreign investors to avoid tax include thin capitalization and taking advantage of the loopholes in tax legislation and the inefficiency in tax administration.

\textsuperscript{72} In 1998, the SAT issued the Administration of Tax on Business Transactions between Affiliated Enterprises Rules (Guoshuifa [1998] No. 59). This Rules provided a comprehensive and consistent practical guideline for TP administration.
The test of what related means between entities is based on common control and ownership. If two entities are regarded as being associated (related), the firm must classify all related inter-entity transactions and account for them according to the Arm’s Length Principle. This applies to transactions between associated companies in tangible or intangible assets and inter-company services.

In April 2003, a new regulation was announced which extended the transfer pricing adjustment period. Under the new regulation, the SAT reserves the right to perform a transfer pricing review within three years, or even ten years under special circumstances, after the transaction initially took place. TP by MNCs has received considerable attention from academics, host-country governments and international organizations (for example OECD).

4.1.1.3. Problems

In theory, the arm’s-length principle is a popular option to deal with TP issues. However, critics have argued that it is difficult to require MNCs to strictly adhere to the Arm’s-Length Principle because MNCs are taking up an increasingly larger

73 An appropriate transfer price should meet the so-called Arm’s length standard. The standard is met if a taxpayer sets its transfer prices in its dealings with related persons so that those prices are the same as the prices used in comparable dealing with unrelated persons.


75 “Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations”, online: OECO, <http://www.oecd.org/document/34/0,3343.en_2649_33753_1915490_1_1_1_1,00.html>

76 John Neighbour “Transfer pricing: Keeping it at arm’s length”, online: OECD observer <http://www.oecdobserver.org/news/fullstory.php?aid=670/Transfer_pricing_Keeping_it_at_a
proportion of the total amount of international transactions. In order to maximize profit, the internal division of labor among multinationals is becoming increasingly detailed. This makes it difficult to find in the international marketplace comparables that can be applied to internal transactions within a multinational group. A comparable transaction can sometimes be found, if lucky, but it often lacks sufficient comparability, making apply the arm’s-length principle.\textsuperscript{77}

4.1.2. Tax Havens

A tax haven is a place where certain taxes are levied at a low rate or are not imposed at all. There are several reasons for a nation to become a tax haven. Some nations may find they do not need so much tax revenue as developed countries in order to earn sufficient income for their annual budgets. Some may offer a lower tax rate to attract larger corporations, in exchange for the companies locating a division of their parent company in the host country and employing some of the local population.

The low tax rate or even no tax encourages MNCs to establish themselves in areas that would otherwise be overlooked. Although China provides tax incentives for FDI, MNCs seek additional ways to pay less tax. China is not the only country facing the “tax haven” problem; it is a world-wide problem in the international taxation field.

The Organisation for Economic Co-operation and Development (OECD) identifies four key factors to be used to determine whether a jurisdiction is a tax haven. The first is that the jurisdiction imposes no or only nominal taxes. This criterion is not sufficient, by itself, to result in characterization as a tax haven. The OECD recognizes that every jurisdiction has a right to determine whether to impose

\textsuperscript{77} See \textless Transfer Pricing Tax System and Its Development in China\textgreater{} by State Administration of Taxation of PRC P11-12
direct taxes and, if so, to determine the appropriate tax rate. An analysis of the other three key factors is needed for a jurisdiction to be considered a tax haven.\textsuperscript{78}

There are approximately 40 tax havens in the world.\textsuperscript{79} Normally, MNCs set up a base company in a tax haven, which means the base company is controlled by foreign investors outside the tax haven. However, the real business transactions are conducted in other companies located outside the tax haven. Then MNCs transfer capital gains and properties to the base company in order to avoid taxation in the host country. Some of the most famous tax havens are Hong Kong, the British Virgin Islands, the Cayman Islands, Panama, Bahamas, and Switzerland.

4.1.3. Thin Capitalization Rules

Thin capitalization is another way for multinational companies to avoid taxes. Developed countries have adopted Thin Capitalization Rules to control the problem.

Thin capitalization (financing by issuing more debt and less equity capital) in general results in a corporation whose capital is supplied primarily by loans from

\textsuperscript{78} They are: Whether there is a lack of transparency; Whether there are laws or administrative practices that prevent the effective exchange of information for tax purposes with other governments on taxpayers benefiting from the no or nominal taxation; Whether there is an absence of a requirement that the activity be substantial. "Tax Haven Criteria", online: OECD,

<http://www.oecd.org/document/23/0,3343,en_2649_201185_30575447_1_1_1_1,00.html>

\textsuperscript{79} A list of Tax Havens: ANDORRA, ANGUILLA, ANTIGUA, ANTILLES, ARUBA, AUSTRALIA, BAHAMAS, BAHRAIN, BARBADOS, BELIZE, BERMUDA, BVI, CANARY ISLES, CANADA, CAYMAN, COOK ISLES, COSTA RICA, CYPRUS, DOMINICA, GIBRALTAR, GREECE, GUERNSEY, IRELAND, ISLE OF MAN, JERSEY, LATVIA, LIECHTENSTEIN, MALTA, MAURITIUS, MONACO, PANAMA, SWITZERLAND, THAILAND, TURKS-CAICOS, UAE, UK, USA, VANUATU, W SAMOA.

Online: <http://www.escapeartist.com/taxhavens/taxhavens.html>
shareholders rather than equity (stock) investment. From the taxation viewpoint, the payment of interest on the debt may be deducted by the corporation as interest expense to earn income, whereas distributions on equity (stock) are nondeductible as distributions out of profits already earned. However, if the debt/equity ratio becomes excessive, the capital structure is unrealistic and the debt is not bona fide. The acceptable debt/equity ratio varies according to industry fields. Thin capitalization is common in developed countries. In order to prevent foreign investors from using excessive debt capital to extract profits in the form of deductible interest rather than as nondeductible dividends, countries have adopted thin capitalization rules. Under these rules, the deduction for interest paid by a resident corporation to a nonresident lender is denied to the extent that the corporation is financed excessively by debt. These rules only apply when a corporation’s equity capital is too small in relation to its debt.

However, thin capitalization is a new method of tax avoidance in China, but many MNCs are engaging in it in China. Although Chinese laws provide that the

80 Online: < http://www.answers.com/topic/thin-capitalization-thin-corporation?cat=biz-fin>
81 See Brian J. Arnold and Michael J. McIntyre, <International Tax Primer>, 137-138
82 <Interim Provisions of the State Administration for Industry and Commerce Concerning the Proportion of Registered Capital and Total Amount of Investment of Chinese-foreign Equity Joint Ventures>

Article 3 The proportion of registered capital and total amount of investment of Chinese-foreign equity joint ventures shall abide by the following provisions:
1. Where the total amount of investment of the Chinese-foreign equity joint venture is less than 3,000,000 U.S. dollars (including 3,000,000 U.S. dollars), the registered capital shall account for seven tenth of the total amount of investment at least. 2. Where the total amount of investment of the Chinese-foreign equity joint venture is between over 3,000,000 U.S. dollars to 10,000,000 U.S. dollars (including 10,000,000 U.S. dollars), the registered capital shall account for half of the total amount of investment at least. Where the total amount of investment is less than 4,200,000 U.S. dollars, the registered capital shall be not less than
ratio between total foreign investment and registered equity capital, in fact, in order to guarantee the investment will be approved, some foreign investors set the total investment amount lower (which means more loans from local banks) than they really invest on purpose so that the ratio meets the requirement of the legislation. It seems that where the FDI bears a heavy debt burden because of the loans, then, the corporation will pay interest to the banks which becomes a deductible business expense and minimizes profit, ultimately decreasing taxes and realizing the objective of tax avoidance.

It can be more complicated, since thin capitalization involves the skills and techniques of tax experts. Unfortunately, it is hard for the officers of the governmental departments in charge of the corporation administration and registration to identify thin capitalization problems. It requires collaboration from diverse parties, like tax services and banking, across society.

4.2. Anti-tax Avoidance and Evasion in the FDI Field

Actually, tax avoidance is permitted by most countries to some extent; however, there is another phrase, called “tax evasion,” which is illegal and usually involves fraudulent or intentional nondisclosure or under-reporting of income. The dividing line between tax avoidance and tax evasion is unclear. Tax evasion is a problem for almost every country because it is worldwide. Not only domestic enterprises engage 2,100,000 U.S. dollars. 3. Where the total amount of investment of the Chinese-foreign equity joint venture is between over 10,000,000 U.S. dollars to 30,000,000 U.S. dollars (including 30,000,000 U.S. dollars), the registered capital shall account for two fifths of the total amount of investment at least. If the total amount of investment is less than 12,500,000 U.S. dollars, the registered capital shall be not less than 5,000,000 U.S. dollars. 4. Where the total amount of investment of the Chinese-foreign equity joint venture is over 30,000,000 U.S. dollars, the registered capital shall account for one third of the total amount of investment at least. If the total amount of investment is less than 36,000,000 U.S. dollars, the registered capital shall be not less than 12,000,000 U.S. dollars. Online: <http://www.lawyer86.com/htm/2974.html>
in tax evasion, official reports indicate that only half of MNCs have indeed registered
to pay tax in Shanghai, while Taiwanese investors are reported to have a particularly
bad reputation regarding tax evasion.83

4.2.1. Bilateral Anti-Tax Evasion Treaties

In order to counter tax evasion, China signed agreements with 60 countries on
double taxation and tax evasion, and 51 agreements were in effect by July 1999. The
first income tax treaty between China and U.S., known as the Agreement for the
Avoidance of Double Taxation and the Prevention of Tax Evasion (Sino-U.S.
Agreement), was signed in 1984. The agreement aimed "to reduce double taxation of
income earned by residents of either country from sources within the other country.
Another goal of the agreement was to prevent avoidance of the income taxes imposed
by the taxing authority of either country."84 Under the treaty, China cannot tax U.S.
business income unless the business activities in China are "substantial enough to
constitute a permanent establishment or fixed base".85 The Sino-Canada agreement

83 See “The Study on the Causes of Tax Evasion in China” by Duojiao Tan, USA-China
Business Review, Inc USA Volume 3 No.1 (Serial No. 19)
84 Article 4 of the Agreement, online:
<http://www.intltaxlaw.eom/treaties/CHINA/treaty.htm#Agreement>
85 To avoid dual levies and tax evasion, China has signed bilateral agreements with 54
countries by the end of 1996, and 48 of them have taken effect.
These countries are Japan, the unites states, France, Britain, Belgium ,Germany ,Malaysia,
Norway, Denmark, Singapore ,Finland ,Canada ,Sweden ,New Zealand ,Thailand , Italy, Holland,
theformerCzechoslovakia,Poland,Australia,theformerYugoslavia ,Bulgaria ,Pakistan ,Kuwait ,Switzerland ,Cyprus ,Spain ,Romania ,Austria ,Brazil, Mongolia ,Hungary, Malta , United Arab
Emirates,Luxembourg, SouthKorea,Russia,PapuaNewGuinea ,India ,Mauritius,Clodia ,Belorussija
a ,Slovenia ,Israel ,Vietnam ,Litoskaja ,Uzbekistan Ukraine. The six countries which are yet to
enact the agreement include turkey, Aminia, Jamaica, Iceland, Latvia and Bangladesh. Facts

59
was signed in 1986, and followed the form according to the model conventions.

Besides those agreements intended to counter tax evasion, there are many other international avoidance of double taxation agreements that have used the conventional OECD and UN models as their building blocks. These include the income tax treaties between the US and Austria in 1996 and between Spain and Portugal in 1993. Although the China-Hong Kong Double Tax Avoidance (hereinafter “DTA”) is not an income tax treaty, it is also comparable to these conventional models. Three income tax treaties that have been signed between China and Japan, the US,

show that these agreements have played an important part in the mutual benefit in the economic development and in tax revenue of both countries as well as in establishing a complete and mature tax system and improving the tax collecting management and enhance China’s position in international activities.

86 Although the wording of some corresponding articles in the OECD and UN models are slightly different, their meanings are essentially the same. Hence, the two models are identical.


91 The Agreement between the Government of the United States of America and the Government of the People’s Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income. The treaty was concluded on 30 April 1984 and became effective on 1 January 1987.
and the UK\textsuperscript{92} are noteworthy. These countries are chosen for several reasons. First and most important is that they are China's major trading partners. Second, the China-Japan Treaty is important for a comparative study of this nature as it was the first international income tax treaty into which China entered. Third, the China-UK Treaty is one of the few tax treaties that China has entered into which covers both income tax and capital gains tax. Fourth, the China-US Treaty has some interesting provisions that are not commonly found in other income tax treaties to which China is a party.

All the treaties assist in countering tax evasion or double taxation to some extent. Each country also tries to develop ways to solve the problem unilaterally. So China is preparing to take a series of unilateral measures to fight against tax evasion by MNCs.

4.2.2. Introducing APA Rules

As previously discussed, about ninety per cent of MNCs engages in tax avoidance by TP. So the major counteraction against TP is the Advance Pricing Arrangement Rules (hereinafter “APA rules”). APA is an arrangement between a taxpayer and the tax authority setting out, in advance of inter-company transactions, the method for determining and calculating the transfer pricing for such transactions. APA is designed to resolve actual or potential TP disputes in a cooperative manner as

\textsuperscript{92} The Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People’s Republic of China for the Reciprocal Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains. The treaty was concluded on 26 July 1984 and became effective on 1 April 1985 (for corporation tax) and 6 April 1985 (for income tax and capital gains tax) in the UK and on 1 January 1985 in China.
an alternative to the traditional defensive approach such as conducting a TP audit. The arrangement is applicable to the purchase, sale and use of tangible or intangible assets, the provision of labor services and financing between a taxpayer and related enterprises. Promulgation of the APA rules suggests that China is paying increasing attention to transfer pricing as a common means of tax evasion by multinational companies and is beginning to take action against tax evasion through it.93

It has taken four years (1999-2002) from the introduction of APA rules to implement the rules. In 1998, China tried to establish APA rules when the SAT issued "The Taxation Management Regulations for Business Transactions between Associated Enterprises" which is widely known as Circular 59. The document suggested which taxpayers may propose pricing principles and calculation methods to the tax authorities to determine transfer prices with associated enterprises.

In September 2002, The Implementation Rules of Tax Collection and Administration Law, Article 53, was issued, which allowed taxpayers to apply to the tax authorities for APA rulings. Since then, more than 130 unilateral APA rulings94 have been concluded, but the lack of uniform, formal rules remained a stumbling block for multinational corporations with subsidiaries in different regions of China. A draft of the APA rules was issued in May 2003 for comment, and the revised

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93 See “China Strengthens Measures Against Tax Evasion” online: <http://www.tdctrade.com/alert/cba-e0410news4.htm>

implementation rules were issued in September 2004.\textsuperscript{95} Introducing the APA for Transactions between Related Enterprises in 2004 made the anti-avoidance revolution more standard and adheres to law as well.\textsuperscript{96}

4.2.3. Recent Anti-Tax Avoidance "Storm"

APA rules indicate that Chinese government notices the importance of anti avoidance regarding FDI taxation. In the recent years, business tax revenue is the largest of China’s sources of tax revenue because of the economic prosperity. However, China is suffering a huge loss of tax revenue because of tax avoidance by MNCs.\textsuperscript{97}

As discussed above, TP is very complicated. Moreover, there is another method which is similar to, but different from, the traditional TP mentioned above. The tax rate of China is much lower than that of most other countries in the world. Some research shows that multinational corporations and foreign investors accelerate investment capital withdraw and transfer the profit to another country where the tax rate is higher than that in China in order to monopolize the profit, and avoid the risk of the foreign exchange losses. This is one way often used to avoid or even evade tax.

\textsuperscript{95} “China claws back the tax ” Feb 07 2005, online:<http://www.fdimagazine.com/news/fullstory.php/aid/1146/China_claws_back_the_tax.html>

\textsuperscript{96} On September 20, 2004, the State Administration of Taxation (SAT) issued the Guo Shui Fa [2004] 118 – “The Implementation Rules on Advanced Pricing Agreement for Transactions between Related Parties”, which provides formal guidance to foreign enterprises in China.

\textsuperscript{97} “China Suffers 30 Billion-yuan (about 3.8 Billion USD) Loss from Tax Evasion by MNCs”, online: xinhuanet,< http://news.xinhuanet.com/fortune/2007-03/26/content_5897101.htm>
It happens when foreign investors collude with domestic companies to evade tax. Sometimes, the managing group of these domestic companies cannot resist the temptation, and they slight avoid their duties and help their foreign partner avoid the tax successfully.

Foreign investors also take advantage of the Chinese company's eagerness for currency. When signing a contract, exchanging foreign cash, managing the company, purchase and sale, the investor uses all kinds of means to transfer the profit abroad and pay little tax. This is one of the diverse of evading taxation, and experts are worried about the consequence from tax avoidance or evasion.

In May 2005, the SAT started an action called "anti-tax avoidance" in China. China has never paid very much attention to the avoidance problem. China was more concerned to attract more investment from overseas to help to develop the economy; but with the FDI increasing steadily, the government began to notice the problems and grey areas arising from those policies. This was the first time the Chinese Tax Bureau focused on anti-avoidance because the statistics disclose a huge loophole such that the government is suffering losses, which is due to tax avoidance from MNCs. Since this "storm" might give rise to the reform of taxation (which proved to be true in March 2007 with the New Enterprise Income Tax Law, which will be discussed in Chapter 5 in detail), it really made the MNCs upset.

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98 It doesn't mean the domestic corporations are not engaging with tax avoidance. So in this chapter, I will discuss the anti-avoidance storm related to FDI corporations only.

4.2.4. Criminal and Social Responsibility regarding Tax Evasion

Most MNCs in China have brought investment, advanced technology, modern corporate governance practices and a sophisticated attitude to social and environmental responsibilities. However, some MNCs in China have tended to ignore or try to reduce their responsibilities and many have even behaved immorally.

In February 2006, the Chinese Academy of International Trade and Economic Cooperation (CAITEC) of the Ministry of Commerce issued its first report on the performance of Corporate Social Responsibility in multinational companies in China —Report on Multinational Companies in China 2005.\textsuperscript{100} The report showed that most MNCs in China have brought with them not only investment and technology but also modern corporate governance practices and advanced perceptions of social and environmental responsibilities. However, the research teams also found some MNCs are associated with bribery, illegally evading taxes, and monopolizing markets.\textsuperscript{101}

According to tax legislation, evading tax could be punished through administrative sanction or by criminal penalty. Theoretically, a criminal penalty could force the taxpayer to fulfill the obligations of paying tax. I think a criminal penalty is better than administrative sanction.

\textsuperscript{100} "The Chinese Academy of International Trade and Economic Cooperation of the Ministry of Commerce: Some Multinational Firms Evade Social Responsibility in China", online: Xinhua news <http://news.xinhuanet.com/fortune/200602/17/content_4190736.html>

\textsuperscript{101} See subtitle 2.1 in "China moves to enhance corporate social responsibility in multinational companies" by Yongnian Zheng and Minjia Chen, China Policy Institute August 2006
Articles 201 and 211 of the Criminal Law of PRC are concerned with income tax evasion, article 201 for the individual and article 211 for the unit. Article 211 outlines the act of and the punishment for income tax evasion for units. The definition of acts of violation for a unit is the same as that in article 201 but the penalties are different. A unit that commits the crimes prohibited by Articles 201, 203-204, or 207-209 shall be sentenced to a fine, and the responsible persons in charge or those directly at fault shall be sentenced according to the provisions of the Articles 201, 203-204, or 207-209 in the same law.

Article 201 Any taxpayer who fails to pay or underpays the amount of taxes payable by means of forging, altering, concealing or destroying without authorization account books or vouchers for the accounts, or overstating expenses or omitting or understating incomes in account books, or refusing to file his tax returns after the tax authorities have notified him to do so or filing false tax returns shall, if the amount of tax evaded accounts for over 10 percent but under 30 percent of the total of taxes payable and over 10,000 yuan but under 100,000 yuan, or if he commits tax evasion again after having been twice subjected to administrative sanctions by the tax authorities for tax evasion, be sentenced to fixed-term imprisonment of not more than three years or criminal detention and shall also be fined not less than one time but not more than five times the amount of tax evaded; if the amount of tax evaded accounts for over 30 percent of the total of taxes payable or is over 100,000 yuan, he shall be sentenced to fixed-term imprisonment of not less than three years but not more than seven years and shall also be fined not less than one time but not more than five times the amount of tax evaded.

Article 211 Where a unit commits the crime mentioned in Article 201, 203, 204, 207, 208 or 209 of this Section, it shall be fined, and the persons who are directly in charge and the other persons who are directly responsible for the crime shall be punished in accordance with the provisions of the Articles respectively.

online:<http://www.zftrans.com/bbs/read.php?tid=1148&fpage=49>
4.3. Problems in Tax Collection and Administration System

A majority of MNCs may honestly pay their taxes to the Chinese tax authority, but a small group of MNCs has allegedly tried to evade taxes. To improve anti-tax avoidance efforts, the government plans to increase supervision on tax sources. Previously, the government required companies to report taxes themselves, then conducted tax assessment and occasional spot checks on these companies. The tax assessment system requires taxpayers to calculate how much to pay and the tax bureau is required to conduct random checks to ensure honesty.

By introducing a preliminary assessment on accounting materials presented by taxpayers before tax inspectors go hunting for fraud, tax authorities can keep closer scrutiny of tax sources, tighten control on tax evasion and distinguish between tax avoidance and honest mistakes. In the process of tax assessment, tax collectors should have a clearer understanding of the taxpayer's business conditions by analyzing taxation and accounting indices, which makes it easier to detect tax evasion. Tax officials also have time to discriminate between unintentional misrepresentations from tax evasion attempts before the taxpayers are wrongly punished. After going through the process of tax assessment, tax inspectors should zero in on major suspected tax dodgers. While the Chinese Government is trying to create a better tax environment for foreign-funded companies, some companies took illegal measures to avoid taxes. An official with Deloitte Touche Tohmatsu (DTT) said tax avoidance through inter-company transactions is a common practice in overseas markets. MNCs often produce process and sell products in different areas. They generally seek advice from
professional accounting firms to determine the transfer prices between different areas. Tax advisers can help corporations optimize transfer pricing and minimize overall tax payments.\textsuperscript{103} While foreign investors generally are concerned about how much they have to pay in taxes, they do not come to China solely because of low taxes. Prudent investors would consider first the investment environment, market situations, infrastructure, and social and political stability.

I would suggest that the government should carry out taxation and auditing of MNCs, expand the scope of joint taxation and auditing, analyze key taxpayer administration and revenue thoroughly, integrate the administration of local key taxpayers, and set up an effective monitoring system of key MNCs' income tax payment.

4.4. Unify the Income Tax Law for all the enterprises located in China

Obviously, tax incentives give a special treatment to foreign investments while it is unfair to domestic enterprises. In such a dilemma, China should unify the two separate income tax laws applicable to domestic and foreign enterprises. In 2006, Chinese Finance Minister Jin Renqing said that the country will provide equal tax treatment for domestic and foreign-funded enterprises as the State Council speeds up tax system reform.\textsuperscript{104} Foreign-funded companies now enjoy preferential tax policies over domestic companies, though nominal income tax was the same for both. A heavier burden for domestic enterprises is neither conducive to fair play nor in line

\textsuperscript{103} <Campaign against tax evasion launched> By Xu Dashan (China Daily) 2004-07-07
\textsuperscript{104} Jin Renqing "It is necessary to unify the two income tax on corporations", online: chinatax <http://www.chinatax.com/news/ViewContent.php?ContentId=7811>
with the practices of the WTO, at a time when China's reform and opening-up drive was entering a new stage.

"The current income tax rules for enterprises should be reformed,"105 as Jin noted, emphasizing that unified tax rules and policies should be enacted for domestic and foreign-funded enterprises while tax rates were appropriately adjusted. Jin did not say what the benchmark for a unified corporate income tax rate would be, but analysts predicted it could be around 20 per cent of a company's revenue. The tax rate for the state-owned firms is currently set at 33 per cent.106

China's tax system is undergoing a systematic review to remove inconsistencies between existing practices and WTO rules. Foreign firms investing in China should prepare themselves to pay higher income taxes. Nowadays, foreign enterprises in China pay about half the taxes that their Chinese counterparts face, as a result of generous incentives granted to foreign investors. Under current Chinese tax legislation, both foreign and domestic firms pay combined national and local income taxes of 33 percent. However, foreign companies that comply with government investment guidelines are granted a preferential income tax rate, typically between 15 per cent and 18 per cent in total. In addition, foreign firms are given full tax exemption for 2 years, and a half exemption for the following 3 years.

105 Jin Renqing “It is necessary to unify the two income tax on corporations”, online: chinatax <http://www.chinatax.com/news/ViewContent.php?ContentId=7811>

Historically, the objectives of tax policies were to attract foreign investment and to promote regional development. These goals have been achieved as China has been among the principal recipients of FDI in the world for over a decade. The total amount of FDI to China increased from US$2.7 billion in 1984 to US$40 billion a year in the late 1990s, and by 2002 the accumulated stock of inward FDI had reached US$440 billion. There can be little doubt that foreign investment has contributed significantly to economic growth in China over the past two decades. In particular, the SEZs, which have flourished and were instrumental in helping the rest of the country to develop, were crucial beneficiaries of the FDI inflows.107

China committed to the uniform application of its laws and regulations to domestic and foreign enterprises in its WTO accession agreement. But the pressure for change is not limited to implementation of China’s WTO accession obligations. Chinese enterprises and economic analysts have also criticized the dual-track system, labeling it “unfair competition”. These critics want to see the tax burden for domestic and foreign firms equalized, and they are going to get their way.108

Chapter 4 mentions the current tax issues regarding FDI in China. Current proposals suggest that the unified tax rate will be set at about 25 per cent which is comparable to corporate tax rates in other jurisdictions, Asian and otherwise. From my point of view, moreover, the tax burden is only one of the factors determining the

rate of return of an investment decreasing, and many foreign companies are interested in China's large, relatively low-cost labor pool, and the huge size and growing wealth of the Chinese market. Corporate tax reform, the new Corporate Income Tax Law of PRC (hereinafter the "CIT Law") will be discussed in Chapter 5.
Chapter 5 Unified Corporate Income Tax Law of PRC

The long-awaited draft unified corporate income tax bill was approved by the Standing Committee of the PRC National People's Congress on December 29 2006. The Corporate Income Tax Law of the People's Republic of China was passed by the PRC National People's Congress on March 16 2007 and will enter into effect on January 2008. The CIT Law has been one of the most discussed topics of the Chinese taxation field in the past few years, and is the result of all those ongoing discussions. Actually, as previously discussed in Chapter 3, due to historical reasons, China does not have an effective tax system for foreign investment. However, when China entered into the WTO in 2001, it has been required that China should improve its tax system as soon as possible in order to comply with the WTO general rules. This chapter contains a discussion of four aspects of the CIT Law: (1) the policy-changing behind the legislation; (2) the WTO rules related to the changes; (3) the main changes of the new law; and (4) the expected influence on the FDI in China in the future. The full text of the CIT Law is provided in Appendix.

5.1. Reform to Unify the Corporate Income Tax Law

In China, there are different taxes levied on Domestic-Funded Enterprises (hereinafter “DFEs”) and Foreign-Funded Enterprises (hereinafter “FFE”). The


110 The current income tax levied on the Domestic-Funded Enterprises enterprise is imposed by the Provisional Regulations of the People's Republic of China on Enterprises Income Tax,
situation of two existing tax systems started in 1994, but was criticized from the time it was created. As early as 2000, the Ministry of Finance of PRC tried to investigate the possibility of unifying the two taxes; however, because of the East Asian Financial Crisis starting from 1997, the investigation ceased. When China joined the WTO in 2001, with the decreasing of tariffs, China pledged to equalize tax treatment for foreign and domestic companies. From that moment, the Ministry of Finance of PRC commenced drafting the legislation.

In August 2004, a draft corporate income tax law was submitted to the State Council of PRC by the Ministry of Finance and the SAT. However, overseas investors urged the government to delay or scrap changes to a system that helped to make the

promulgated by the State Council on January 1st, 1994. The domestic corporate tax applies to the State-Owned Enterprises, Collectively Owned Enterprises and Private Enterprises, while the income tax levied on Chinese enterprises with foreign investment, foreign invested enterprises and foreign enterprises that have set up permanent establishments or have income from China, is Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises and the detailed rules and regulations. Thus, there are different income tax systems for Domestic-Funded Enterprises and Foreign-funded Enterprises, with different taxpayers, object of taxation, rates of tax, rules for computing taxable income, and tax preferential policies.

111 As discussed in Chapter 3, it was a big change in China’s tax legislation in 1994 when the legislators create two income tax laws for domestic enterprises and foreign enterprises.

112 The East Asian Financial Crisis was a period of economic unrest (or financial contagion) that started in July 1997 in Thailand and South Korea with the financial collapse of Kia, and affected currencies, stock markets, and other asset prices in the Asian countries known as the Four Asian Tigers. online: wikipeida,

<http://en.wikipedia.org/wiki/Asian_financial_crisis#China>
country the world’s largest recipient of FDI. At the beginning of 2005, General Electric, BP and Siemens were among the companies that lobbied the Chinese government to postpone the ending of foreign tax benefits. The group submitted a report to the State Council, or cabinet, asking for a 5-10 year transition period before they would be taxed at the same rate as Chinese companies.\(^{113}\) Obviously, it was not a simple reform of tax. Fortunately, the draft was announced to be discussed as the most important legislation in 2006 by the Chinese People’s Political Consultative Conference (Quan Guo Zheng Xie).

The legislative progress was complicated, and the discussion in the pages that follow highlights some main points. In a nutshell, the complication arose from the coexistence of two parts, domestic and foreign. Theoretically, the different tax systems for the DFEs and the FFEs violate the national treatment (which will be discussed in subtitle 5.2 in this Chapter), the WTO rules and the direction of the current taxation reform around the world. The national treatment is also called nondiscrimination treatment, which is the basic principle of the WTO. On one hand, it requires that the taxation treatment enjoyed by the foreign enterprises is not lower than the national residents, and on the other hand, not higher than the national residents in any way. But both the non-national treatment and the super-national treatment exist in China.

\(^{113}\) \("The report of 54 multinational companies is not totally true"\) China Business News (17 Jan 2005, online: Sina <http://finance.sina.com.cn/g/20050117/05241298013.shtml>
Moreover, the two different taxation systems violate tax principles, including the equality principle and the efficiency principle. According to the Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises, the foreign-enterprises may enjoy a great deal of tax preferential policies, such as two year tax-free, three year half-tax and tax reimbursement if profits are invested again and so on. However, the actual burden of taxation for DFEs is about 25 per cent which is much higher than the 15 per cent burden of taxation for the FFEs. That is quite unfair for the DFEs, especially after China has entered WTO and the large inflows of foreign capital into China, which leaves the DFEs in an unequal competitive environment, and places the DFEs at a disadvantage at home and abroad.

On the other hand, the efficiency principle of taxation requires the minimal expense to generate the most tax revenue, together with promoting economic development, or reducing the hindrance of taxation to economic development. The administrative efficiency principle of taxation mainly covers the taxation expenses and the expense of paying tax, which requires the tax authorities to pay more attention on the administrative efficiency to save the expense of administering taxation and compliance cost to taxpayers. With the two different systems, the national tax authorities and the local tax authorities separately levy taxes, which increase expense and friction between the authorities, lowering the efficiency of levying tax.114

The economic efficiency principle of taxation means optimizing the tax system to reduce the ill effects of taxation on the economy, or to promote its smooth development. However, the two different tax systems and the tax preferences, are contrary to the neutral principle of taxation, distort the market economy and adversely affect the efficient allocation of scarce resources.

5.2. A Major Step towards Compliance with National Treatment Principle of the WTO

China tried to readjust its taxation system to meet the requirements of the WTO since 2001. As mentioned previously in this thesis, China implemented a major reform of its industrial and commercial tax in 1994. There should be only one standard for the corporate income tax according to common international practice, however there were two in China: one for domestic entities and another for foreign entities (enterprises with foreign investment and foreign enterprises). Foreign entities are entitled to many concessions in their income tax.

On joining the WTO, the Chinese tax system had to change step by step to meet the requirements of WTO rules and basic principles. In the previous six years, some changes in taxation had already been made such as the new individual income tax law.115 In the corporate taxation field, due to Chinese State-Owned Enterprises (hereinafter “SOEs”) reform, private enterprises (Min Ying Qi Ye) replaced

115 The Law of the People's Republic of China on Individual Income Tax was amended for the third time in accordance with the Decision of the 18th Session of the Standing Committee of the Tenth National People's Congress on October 27, 2005

Online:< http://www.lawinfochina.com/law/display.asp?db=1&id=4644>
state-owned enterprises in the nation's economy.\textsuperscript{116} As a result, private enterprises may enter some new fields which were formerly open only to the SOEs, which meant the income tax, which used to be levied on SOEs was imposed on private taxpayers. As a result, in their own interest, private owners began to voice the claim of "unify the income tax of corporations," because they wanted to be treated fairly.

As to the equality, some support the view that the difference between domestic entities and foreign ones in the income tax system which gives more tax preference to the foreign entities, is in contravention of the National Treatment principle. Actually, the preference created a "super National Treatment" for foreign enterprises in taxation which is more favorable than National Treatment. Furthermore, this policy also created a gap between domestic enterprises and foreign ones such that enterprises with foreign investment, and foreign enterprises, received many benefits under this policy. In order to qualify for the tax preference giving to foreign enterprises only, many domestic entities used different ways to establish "fake" foreign entities, which caused some social problems.\textsuperscript{117} The "fake" foreign enterprises not only led to

\textsuperscript{116} Under the guidelines of the Third Plenary Session of the 16th CPC Central Committee, the All-China Federation of Industry and Commerce submitted its "Proposal for Encouraging Private Enterprises to Participate in State-owned Enterprise Reconstruction." It suggests encouraging private enterprises to participate in the reorganization of SOEs.

\textsuperscript{117} Fake FDI means money that flows out of China before returning disguised as foreign investment. China has been one of the world's top destinations for FDI. It received inflows totaling US$53.5 billion in 2003, US$60.6 billion in 2004 and US$60.3 billion in 2005. However, looking at top foreign investment sources show that the British Virgin Islands and Cayman Islands ranked among them for several years. Although investors from some
harmful competition but also reduced the amounts of tax collection which made the
government revenue suffer for several years.

From my point of view, China has its unique advantages to attract foreign
investment such as abundant human resources, social stability and an irreplaceable
market. And I think a fair and stable investing environment means more to foreign
investors than tax considerations. Hopefully, the unification of corporate tax law may
end the “fake” FDI to build a healthy commercial environment for competition.

When Chinese domestic enterprises are hoping for National Treatment on
themselves, their foreign rivals are enjoying the Super National Treatment. Did it
break the WTO rules and constitute discrimination? It is necessary to analyze the
definition of National Treatment principle. The principle was established with the
development of global trade and international trade treaties. Under this principle, the
states contract to treat natural persons and legal persons of other states as same as the
domestic ones. OECD definite this principle as following: "National Treatment" is the
commitment by a country to treat enterprises operating on its territory, but controlled
by the nationals of another country, no less favorably than domestic enterprises in like
situations. This commitment is enshrined in the Declaration on International

other countries registered there to take advantage of low taxes, quite a number of them are
Chinese business people. Fake FDI is estimated to be around 10 per cent of the total actual
foreign investment in China. The abolition of favorable treatment for foreign investment is
expected to reduce the percentage of fake FDI.

“Experts: Reform Won't Shrink FDI” China Daily (December 26, 2006),online: People's
Investment and Multinational Enterprises, adopted in 1976 by the Governments of the OECD Member countries.\textsuperscript{118} The principle of “national treatment” (giving others the same treatment as one’s own nationals) is also found in all three main WTO agreements (Article 3 of GATT, Article 17 of GATS and Article 3 of TRIPS), although it is defined slightly differently.

In the special case of China, the complaint of discrimination did not come from the foreign party but from the domestic party. I think in this case, the tax preference policy provided by China to FDI constituted discrimination against domestic enterprises. Although the National Treatment principle defines the discrimination based on the foreign party, \textit{vice versa}, it is also kind of violation to the principle if the domestic party was treated unfairly.

5.3. The Main Reforms in the CIT Law

The CIT Law will be implemented on January 1st, 2008. In general, foreign-invested enterprises will no longer enjoy the preferential rate which was lower by 10 percentage points than that imposed on domestic enterprises, and must pay the same uniform 25 per cent income tax as domestic-funded enterprises. Foreign-funded enterprises that had received the super-national treatment policy in urban land use ceased to receive it in early 2007. According to the published prescript of 2006, Foreign-funded enterprises must be levied the same tax as their domestic counterparts.

\textsuperscript{118} See “Directorate for Financial and Enterprise Affairs: National Treatment for Foreign-controlled enterprises” (2004 edition)
in the use of urban land from January 1st 2007. After the first step of unification for paying land using tax, here comes the unification of corporate income taxation.

The CIT law is not limited to the debated unified tax rate for both domestic and foreign enterprises; it also changes the current tax holiday and preferential tax treatments and grandfather provisions. Moreover, for those companies currently qualifying for income tax rates of 15 per cent to 24 per cent, the new law provides a five-year adjustment period. To attract investment in the high technology sector, the new tax law is set to provide a preferential 15 per cent rate for companies operating in this area, which is the main field of many foreign companies already operating in China.

When the new law was introduced, many accounting firms published their own analyses. Comparing the current dual tax laws and the new one, some key points will be helpful to be listed, as follows: (1) Unified 25 per cent Tax Rate (2) Definition

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119 The Chinese government decided to double tax rates on urban land use, from those set in 1988. Chinese Premier Wen Jiabao signed an order of the State Council to revise the provisional regulations on taxes on urban land use issued in 1988. The increased tax rates apply to domestic businesses, foreign-funded enterprises in China and foreign companies. The policy also stripped local governments of their authority to spend the money from land sales, and orders that the revenue be incorporated into local budgets to allow supervision by higher authorities and local legislative bodies. Under the policy, the government may raise taxes from investors for the use of land, which will be used for the protection and development of farmland.

120 The Big Four international accounting firms including PricewaterhouseCoopers, Deloitte Touche Tohmatsu, Ernst & Young and KPMG published their own analyses of the new CIT law.

5.3.1. Unified 25 per cent Tax Rate

As previously stated, the unified tax rate will be between 24 per cent and 27 per cent. In practice, the new law establishes a unified 25 per cent tax rate. With exceptions for qualified enterprises with small profits and to encourage technological enterprises, both domestic companies and FIEs in China are generally subject to the 25 per cent rate.

5.3.2. Definition of Taxpayers

Under the CIT Law, “enterprises and other income receiving organizations” are subject to enterprise income tax. Sole proprietorships and partnerships are not subject to this law. Enterprises are classified as “Resident Enterprises” and “Non-Resident Enterprises.”

121 A qualified enterprise retains the 20 per cent preferential tax rate.

122 Article 3 of the new CIT law The EIT Law provides for three different tax rates as follows:

15 per cent: applicable to “encouraged” high-tech enterprises, regardless of the location of the enterprises in China. 20 per cent: applicable to small-scale enterprises earning a “thin profit” and non-resident enterprise generating income from sources in China. 25 per cent: applicable to all enterprises other than those mentioned above. Under the current tax law, the standard statutory income tax rate is 33 per cent, while FIEs may enjoy a preferential tax rate of 24 per cent or 15 per cent and five-year tax holidays from the first profit-making year.

123 Actually, the resident enterprise is kind of the image of a permanent establishment ("PE") which China levied tax on offshore companies whose activities and presence in the country cross a threshold such that they are deemed to be doing business in China and subject to
“Resident Enterprise” refers to an enterprise established within the territory of China pursuant to Chinese laws or an enterprise established within the territory of another country or other tax region pursuant to foreign laws whose actual management or control is located in China.

“Non-Resident Enterprise” refers to an enterprise established within the territory of another country or other tax region pursuant to foreign laws, whose actual management or control is located outside of China but has an establishment in China, or even if it does not have an establishment in China, has income derived from China.

5.3.3 New Incentive Policy and “Grandfather Rule” for Existing Incentives

The new law reflects a policy shift from the current tax holidays and tax rate reductions for manufacturing in general and for certain specific locations to focus on encouraged industries and social issues, along with some regional-based preferential treatment.124 The new regime adopts the "Predominantly Industry-oriented, Limited Geography-based" tax incentive policy, which is a significant deviation from the income tax. There is difference between PE and Resident Enterprises in the new law. In terms of PE, a foreign enterprise's China source income is subject to taxation, while the worldwide income of a resident enterprise could be subject to tax in China. In particular, foreign companies with regional headquarters or management offices in China will need to be careful with the interpretation and implementation of the resident enterprise concept.

124 The current incentives will be expanded for high-tech enterprises and research and development activities. Just a few weeks before the New Law was adopted the SAT issued a circular to address the preferential tax policy for venture capital. With the adoption of the New Law, it is expected that a more complete incentive tax system with detail implementation rules will be issued in the near future.
existing regime. The Law clearly reflects the government focus on technological
development, environment protection, energy conservation, production safety, venture
capital and continuing investment in agriculture, forestry, animal husbandry, fisheries
and infrastructure development.  

Under the CIT Law, new high-tech enterprises that are specified as supported by
the State established in the SEZs and the Pudong New Area would enjoy certain
transitional preferential tax treatments. Furthermore, the preferential tax treatments
for "Encouraged Enterprises" located in the Western Region will remain.  

The new law will revoke the existing five-year tax holidays (two years of
exemption and three years of reduction to one-half the usual rate) for Manufacturing
FIEs, as well as extensions of such tax holidays. Instead, it provides a grandfathering
treatment. The “grandfather rule” for the incentives is quite reasonable, to provide
the FIEs a transitional period because it is concerned with different situations.

126 See CIT law Article 27
127 Id., Article 57
128 “Grandfather Rule” is stated in the Article 57 of the new CIT law “Enterprises that are subject to a reduced income tax under the existing law will be eligible for a five-year transition period during which the tax rate will gradually increase to the unified rate by 2 percent per year. Manufacturing FIEs which have not fully utilized their five-year tax holidays, will be allowed to continue receive the benefits of the “tax holiday” during the five-year grandfathering period. For those FIEs which have not yet begun the “tax holiday” period, the “tax holiday” period will be deemed to have commenced from the effective date of the CIT Law”. 
Enterprises that are subject to a reduced income tax under the existing law will be eligible for a five-year transition period and will gradually increase to the unified tax rate\textsuperscript{129} as long as the enterprises were approved to set up before the announcement date of the CIT law. The official “announcement date” of the New Law is 16 March 2007.\textsuperscript{130} In other words, foreign investors that have received approval from the applicable foreign investment committee before that date should have their FIE covered by the grandfather rule. These enterprises will also be able to utilize other tax holidays under prior law until they expire.

However, if an enterprise has not yet commenced a term holiday because it has not recognized its first year of profit, then the enterprise will be required to commence the term holiday immediately from the effective date of the CIT Law which is Jan 1\textsuperscript{18} 2008. For example, if a special FIE incentives end after 2012 because the first year of profits is, for example, 2009, then the five-year incentive period will be considered to begin in 2008. Since 2008 for such an FIE is a loss year, it appears that this FIE would

\textsuperscript{129} It has been reported that the Minister of Finance, Mr. Jinrenqing, has stated that the implementation of the grandfather rule will result in an incremental increase in the tax rate from 15per cent to 25per cent during the transition period, which means a 2per cent increase per year, i.e. 17per cent for 2008, 19per cent for 2009, etc.


\textsuperscript{130} However, from my part of view, the law did not define which day is the real approval date. The new CIT law should be interpreted by the authorities to make the date of issuance of the preliminary business license by the State Administration of Industry and Commerce the relevant date. The preliminary business license date defines the first day of existence of a new enterprise.
effectively have only one year of tax holiday (2009) and three years of the 50 per cent reduced rate (2010-2012). Any benefits for 2013 that would have been realized under the old rules will be completely lost. According to what I mentioned in Chapter 4, before the new law is enacted, the “two plus three” incentive policy was used to avoid tax paying in different ways such as claiming more loss so that the FIEs could enjoy the incentive period longer. The grandfather rules will eliminate the “grey area” for tax avoidance by expressly providing for the different situations eligible for “two plus three” rules.

Moreover, Article 57 of the new CIT law also provides that enterprises in zones that were established to attract foreign investment and technological development will continue to be eligible for tax holidays subject to grandfather rules that will be addressed in "detailed regulations" to be issued by the State Council. For those enterprises operating in an encouraged sector of the economy may be eligible for tax holidays, also subject to forthcoming guidance from the State Council.\textsuperscript{131}

\textbf{5.3.4. Unified Tax Deduction Policies}

Domestic enterprises and foreign-funded enterprises are now subject to different deduction of costs and other expenditures. For example, a limited deductible salary and wage system applies to the income tax of domestic enterprises while an actual salary and wage deduction system applies to the income tax of foreign-funded enterprises. Currently, domestic companies are subject to certain limitations on specific types of expenses. The new law eliminates those limitations and unifies the

\textsuperscript{131} See CIT law Article 57
policy for deducting various actual expenditures of enterprises, prescribes the standards for deducting expenditures for public welfare donations (Article 9) and defines the scope of nondeductible expenditures (Article 10). It also makes unified provisions for the deduction of expenditures related to an enterprise's fixed assets, intangibles, long-term prepaid expenses, and investment assets and inventory (Articles 11 to 16).

5.3.5 Notable Provision--Anti-Avoidance

The discussion of tax avoidance in Chapter 4 preceded the CIT law. Tax avoidance by some enterprises through various means is serious, and the struggle against tax avoidance is intense. Thus, on the basis of international practice, the new law provides rules for preventing tax avoidance through TP among associated enterprises. It also provides general anti-avoidance rules and articles against thin capitalization and avoidance through tax havens. Moreover, it sets forth provisions for assessment procedures and collection of interest from settling tax arrears as provided for by the State Council. This will help guard against and prevent tax avoidance and safeguard the interests of the state.132

China has been making rapid progress in developing TP rules. The special tax adjustment chapter is a milestone for past TP practice. The concept remains the arm’s-length rule. Any related-party transaction not conducted on an arm’s-length basis could be subject to a TP review and adjustment by the tax authority. However, existing TP rules do not have any significant penalties. Under the New CIT Law, any

132 See Chapter VI of the CIT Law “Special Tax Adjustment”
tax increase resulting from an adjustment by the tax authority would be subject to late-payment interest in accordance with State Council rules.\textsuperscript{133}

Moreover, APAs are also codified allowing taxpayers the opportunity to take advantage of APAs to facilitate related-party transactions. The special tax adjustment chapter contains a general anti-tax avoidance clause.\textsuperscript{134} Any transaction that lacks a reasonable business purpose and results in a decrease in taxable income is subject to adjustment by the tax authority. The tax authority would have the legal basis to challenge any transaction on the basis of tax avoidance.\textsuperscript{135} In the author’s opinion, this article raises significant concerns such as what the appropriate standards are to determine the lack of a reasonable business purpose and which authority should have the final decision-making power. It will be a long-term challenge for the SAT to ensure consistent enforcement of the new general anti-tax avoidance rule. I recommend taxpayers bear this rule in mind when structuring tax effective transactions and operations.

**5.4. Prospective Impact of the New Law—What is the Next**

Most of the new reforms are mentioned above. The new corporate tax law will pave the way for the equalization of the corporate tax rates paid by foreign and local companies, to be levied at 25 per cent. According to Minister of Finance Jin Renqing, the corporate tax reform is expected to collectively cost foreign companies a total of 43 billion yuan (US$ 5.5 billion) extra annually. Now that the new PRC Corporate

\textsuperscript{133} See Article 48 of the CIT Law
\textsuperscript{134} See Article 41 of the CIT Law
\textsuperscript{135} See Article 47 of the CIT Law
Income Tax Law will take effect next year, foreign investors should consider whether it is appropriate to restructure their investments in China to cope with the changes.\textsuperscript{136} No wonder there are also some aspects for domestic enterprises to be think over when they are making their investments within China.

For domestic enterprises, in general, the new law will eliminate some problems due to unfair tax burden. The existing different tax treatment on the domestic-enterprise and the foreign-enterprise makes the enterprises always compare with each other to ask for more tax preference.\textsuperscript{137} Together with the shared tax between the central government and the local government and the effect of the interest and regional protectionism, some places broaden the tax preference and reduce the tax freely to attract more foreign capital, which is really a big problem to cause the loss of taxation revenue. The nominal tax rate applicable to domestic enterprises will drop from 33 per cent to 25 per cent, and the new law eliminates the deduction limits on certain costs and expenses that have been applicable only to domestic enterprises.

\textsuperscript{137}For example, due to the existing high rate of tax on domestic businesses, in fact, to dodge the tax some enterprises put a large sum of money on account in the form of public accumulation fund for housing construction(zhu fang gong ji jin) to enlarge the expense and reduce the payable tax, however this sum of money is never given to the workers unless the workers buy the house, otherwise this money will be the capital freely dealt with by the enterprises by investing on the reproduction round and round. Thus, the high rate of tax for domestic-enterprises increases the possibility of dodging the tax, which is harmful for the adjusting the tax and the development of national economy.
before. I think many domestic enterprises will have major reductions in their tax burden. In terms of "fake FDI" that I mentioned, the new incentive changes will help to reduce the practice of "round-tripping," whereby domestic enterprises take advantage of the incentives applicable to FIEs by transferring domestic capital overseas and then making inbound investments (fake FDI).

For the foreign part, with the cancellation of the general manufacturing tax holidays, FIEs engaging in certain traditional industries (e.g. manufacturing low-end products, labor-intensive production) will face with negative impacts. For these enterprises to qualify for tax incentives under new law, they will have to consider new measures such as raising the high/new-tech content of their products and production technology, as well as purchasing capital goods for enhancing environmental protection, water and energy conservation, and production safety in order to qualify for the new investment tax credit.

Although the tax bill was expected to add 43 billion yuan to foreign firms' collective tax bill annually, I don't think it would have a very adverse impact on FDI levels. This is partly because many foreign companies operating in China find themselves within the high-technology sector, which will be exempted from increased corporate tax. Meanwhile, a corporate tax rate of 25 per cent still leaves China in a competitive position with the five-year transitional period. I don't think FDI is wholly dependent on the tax preference, and is attracted mostly because of the large market and the low production cost in China. Chinese tax preferences to foreign-enterprises do not necessarily benefit the recipients because they may not actually keep them in
every case. Take the United States tax system for example; it implements resident (citizen) and source jurisdictions to tax, which means that the foreigner in China, that is also resident in the U.S, pays the Chinese tax preference back to the American government. Thus, it is obvious providing the tax preference does not mean the foreign-enterprise retains the benefit.

Whether transnational investors can enjoy the tax preference or not depends on whether the capital-importing country implements tax sparing. If there exists the tax sparing system, the tax preference belongs to the investors otherwise it belong to the capital-exporting country. Although more than 100 countries have implemented tax sparing systems, there are still many countries that did not implement it, including some developed countries like the United States. As the biggest capital-exporting country to China, the U.S. did not recognize tax sparing in regard to China, which means that the tax preference China provided to the foreign-enterprise did not remain with the foreign-enterprise but went to the capital-exporting country. In a nutshell, although the CIT Law eliminates tax preferences, I am optimistic for the future of FDI in China.

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138 Kong Xia “It is necessary to unify the corporate income tax law”(tong yi shui fa bi yao zhi wo jian) online: <http://www.cftl.cn/show.asp?c_id=540&a_id=4195>
Conclusion

The CIT Law announces a fundamental change to China's tax policy towards foreign investors. I recommend that existing foreign investors should review their tax profile, conduct an impact analysis and revisit their current tax planning structures against the new tax regime in China. There will be a need for new thinking and strategy to minimize China income tax.

For the view of Chinese government, the CIT reform has gone through a long process. There are still many unanswered questions regarding how the new CIT law will be implemented and the answers to these questions are important matters relevant to foreign investors whether they have established a business presence in China or are contemplating doing so. The State Council, China's highest administrative body, which will promulgate the detailed implementation rules, has not yet indicated when the rules will be available. Given the substantial changes to China's tax laws and policies contained in the CIT Law, foreign investors that already have investments in China will need to analyze their impact and update their tax profiles to comply with the new rules. For those considering entering the China market, a careful analysis of the CIT Law incentives and taxation is required.

Comparatively, I think it is more difficult for foreign enterprises than domestic enterprises to re-plan a new tax strategy because tax reform will inevitably increase FIE’s income tax burden in China, particularly those currently receiving tax incentives. FIE's operating in China need to consider the implications of the changes and take
appropriate action to make most of the tax benefits available, and re-visit their tax planning strategies for the long run. Meanwhile, foreign enterprises and their advisers need the implementation rules for the CIT Law as soon as possible to plan more efficiently.
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# Glossary

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Definition</th>
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| APA rules    | Advance Pricing Arrangement Rules  
An agreement between a multinational enterprise and the tax authorities of one or more countries approving the transfer pricing method to be used by the enterprise in future tax years. |
| CJV          | Cooperative Joint Venture  
Another FIE in which the distribution of profits does not depend on the partners' shares in equity capital but is determined by agreement between the partners in the contract. Cooperative joint-ventures have been widely used, especially by Hong Kong firms, even before they received a legal status, as the law on cooperative-joint-venture was passed only in April 1988. |
| DFE          | Chinese Domestic Funded Enterprise (General Expression) |
| EJV          | Equity Joint Venture  
The first form of FIE to be authorized by the Equity Joint Venture law, in July 1979, which stipulates that foreign capital must account at least for 25% of the total capital of a joint-venture. |
| FDI          | Foreign Direct Investment |
| FIE          | Foreign Investment Enterprise (General expression) |
| FFE          | Foreign Funded Enterprise (General Expression) |
| MNC          | Multinational Company |
| NPC          | National People's Congress of PRC |
| SAT          | State Administration of Taxation of PRC |
| SOE          | Chinese State-Owned Enterprises |
| TP           | Transfer Pricing |
| WFOE         | Wholly Foreign-Owned Enterprises with 100 per cent foreign capital were authorized in 1986 by a law which imposed two conditions: the wholly foreign firms should export at least 50% of their production or produce technologically-advanced goods. |
APPENDICES

Appendix I

Sino-Foreign Tax Treaties For the Avoidance of Double Taxation

EFFECTIVE TAX TREATIES

Source: State Administration of Tax—China

<http://www.chinatax.gov.cn/n480462/n480513/n481009/index.html>

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# Appendix II

## Summary of Key Aspects of China Corporate Income Tax Law

*Source:* PRICEWATERHOUSECOOPERS China Tax 2007 Issue 6

<table>
<thead>
<tr>
<th>Key Aspects</th>
<th>Key Changes in Unified CIT Law</th>
<th>Observations</th>
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<tbody>
<tr>
<td>Concept of &quot;Tax Resident Enterprise&quot; (&quot;TRE&quot;)</td>
<td>TRE concept is introduced whereby TREs are subject to China income tax on worldwide income, and non-TREs on China source income. FIEs registered in China are always TRE. Foreign Enterprise (&quot;FE&quot;) whose effective management institute is based in China is regarded as a &quot;TRE&quot;. This new concept goes beyond the current &quot;Permanent Establishment&quot; concept which taxes FEIs only on their China source income.</td>
<td>The move towards taxing enterprises depending on their residency status may seem like a significant change to the taxing principles. First of all, this change is just to make China CIT regime consistent with many other tax jurisdictions and is consistent with tax treaties. DEs and FIEs are unaffected by the change because they are taxed in China anyway. An FE without its effective management institute based in China is taxed the same way as before depending on whether it has a PE or not. It is only in the cases where an FE may be considered to have its effective management based in China that will be caught under this new provision. The definition of &quot;effective management institute&quot; is not provided under CIT Law. FIEs need to be careful about the &quot;effective management institute&quot; rule when they consider undertaking more regional management functions within China including regional headquarters.</td>
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<td>Key Aspects</td>
<td>Key Changes in Unified CIT Law</td>
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<tr>
<td>Tax Rate - FIEs</td>
<td>Standardized rate of 25 per cent, with reduced rate of 20 per cent for qualified small and thin-profit companies. 15 per cent for encouraged high/new-tech enterprises. FIEs approved before the publication date of the CIT Law and currently taxed at 15 per cent or 24 per cent will be offered a gradual increase to 25 per cent within 5 years.</td>
<td>High/new tech enterprises no longer need to be located within so called high-tech parks and can enjoy tax incentives wherever located. The definition of &quot;high/new-tech enterprises&quot; is not yet available. It is believed that the scope of eligible enterprises will be subject to adjustment from time to time in line of the economic development goals set by the State.</td>
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<td>Tax Rate - FE</td>
<td>20 per cent withholding tax (&quot;WHT&quot;) rate for passive income derived by Non-TREs.</td>
<td>The Law has not addressed whether the current provisional 10 per cent WHT rate on passive income and the WHT exemption on FIE's dividends to their foreign investors may continue. CIT Law has a specific provision allowing for reduction / exemption of WHT. Hence, if China considers necessary to keep current treatment, there is a framework to grant such relief. Foreign investors may explore potential use of a Special Purpose Vehicle resident in treaty countries/regions to do WHT planning.</td>
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| Tax Incentive Policies | Tax reduction and exemption treatments are targeted primarily towards (i) agriculture, forestry and animal-husbandry, fishery projects, (ii) basic infrastructure projects; (iii) environment protection projects and energy/water conservative projects; (iv) qualified technology transfer.  
"Super deduction" is allowed for R&D expenses for new technology, new products, and new craftsmanship.  
Taxable income may be reduced by a deemed deduction calculated as a percentage of investment amounts for venture capital businesses engaged in encouraged industries.  
Shorter tax depreciation life or accelerated depreciation is allowed for particular types of fixed assets due to advancement of technology.  
Reduction allowance may be allowed for revenue earned from products manufactured with comprehensive resources pursuant to the State industry policies.  
Investment tax credit is allowed on qualifying expenditures on plant and machinery for environmental protection, energy and water conservation, and production safety. | The tax incentive policy is shifting from "Geography-based" tax incentives to "Pre-dominantly Industry-oriented, Limited Geography-based" tax incentive policy. The new tax incentive policy is focused on high/new technology which is critical to China's future success.  
"Production FIEs" and "Export-oriented FIEs" in general industries may enjoy only limited incentives via qualifying R&D activities and capital investments, etc.  
The scope of basic infrastructure projects eligible for tax preference is subject to further stipulation and adjustments by the State Council from time to time in line of the economic development goals.  
No details yet as to what are the incentives, and how to apply the new tax incentives, e.g. criteria, standards, proportion, or periods.  
Does not appear that the reinvestment tax refund benefit for FEs would survive. |
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<th>Key Aspects</th>
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<td>Key Aspects</td>
<td>Key Changes in Unified CIT Law</td>
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<tr>
<td>Grandfathering of previous</td>
<td>Unused tax holiday of FIEs approved to be established before CIT Law is grandfathered till the expiry. Where the tax holiday has not yet started because of tax losses, it shall be deemed to commence from the first effective year of Unified CIT Law. New FIEs which engage in high/new-tech industries encouraged by the State and located in SEZs and Pudong may enjoy transitional preferential treatments (to be defined). Enterprises in encouraged industries located in Western regions would continue to enjoy the existing tax incentives.</td>
<td>The forced start date of the holiday in 2008 appears to aim at bringing the transition period to a close as quickly as possible. It also deters FIEs from using various tactics to postpone profit-making year in order to leave the low rate to future years. It is unclear what transitional preferential treatments would be granted to new FIEs in high/new-tech industries located in SEZs and Pudong.</td>
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<td>preferential tax treatments</td>
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<tr>
<td>Tax Deductions</td>
<td>Most rules similar to current law for FIEs. Charitable donation is limited with a cap. Non-deductible expenses have been expanded to include sponsorship expenses, and unverified provisions and reserves.</td>
<td>DEs will face less limitation in deducting expenses when compared to before. But FIEs will be subject to new deduction limitations, e.g. sponsorship fees. Definition of sponsorship fees is not available yet. CIT Law does not mention deduction caps for entertainment expenses which may be addressed in the Implementation Rules.</td>
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<tr>
<td>Anti-avoidance</td>
<td>Cost sharing is allowed in respect of intangible assets developed and shared among related parties, and for the provision and receiving of common services, as long as the sharing basis is on arm's length. More stringent requirements on filing and submission of related party information for TP enforcement. &quot;Controlled Foreign Corporation Rules&quot; (&quot;CFC Rules&quot;) such that undistributed profits derived by CFCs located in low-tax jurisdictions may be taxed in China as a deemed distribution. &quot;Thin-capitalization Rule&quot; such that excessive interest expense may be disallowed. General anti-avoidance provision for making adjustments to taxable revenue or taxable income where business transactions are regarded as arranged without reasonable commercial purpose. Tax adjustments made under the Anti-avoidance Chapter may be subject to interest levy.</td>
<td>China may not have much experience in implementing cost sharing arrangements (&quot;CSA&quot;). So it remains to be seen as to the practical aspect of this rule. Actual experience suggests that extra care and significant effort is required to negotiate, substantiate and sustain the tax positions of CSAs. Annual TP Documentation Requirements are expected to be introduced to echo to various TP provisions in the Law. CFC rules are introduced for the first time to tackle anti-avoidance arrangements of DEs as they invest and operate overseas. All the anti-avoidance provisions under this new Chapter are commonly seen internationally. Hopefully the forthcoming implementation rules will clearly establish the definitions of anti-avoidance activities and situations. Otherwise there could be disputes between taxpayers and tax authorities in practice over this matter. &quot;Interest levy&quot; on anti-avoidance adjustment will serve as &quot;teeth&quot; in the law.</td>
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<tr>
<td>Key Aspects</td>
<td>Key Changes in Unified CIT Law</td>
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<tr>
<td>Tax Consolidated Filing for</td>
<td>Not allowed unless approved by State Council.</td>
<td>Tax consolidated filing is currently allowed for some domestic state-owned</td>
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<tr>
<td>Groups of companies</td>
<td></td>
<td>conglomerates under special approval of the State Council. It is uncertain</td>
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<td>whether FIE groups in the future may apply for consolidated tax filing in</td>
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<td></td>
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<td>light of the &quot;National Treatment&quot; principle.</td>
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<tr>
<td>Tax Filing Administration</td>
<td>Filing of annual tax return period is extended to 5 months (from 4 months now) after year end.</td>
<td>Not clear who may be subject to monthly provisional filings. FIEs clearly</td>
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<td></td>
<td>Provisional reporting and payments may be made on monthly basis or quarterly basis.</td>
<td>prefer to continue quarterly reporting.</td>
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Appendix III

The General Agreement on Tariffs and Trade (GATT 1947)

Article III: National Treatment on Internal Taxation and Regulation

1. The contracting parties recognize that internal taxes and other internal charges, and laws, regulations and requirements affecting the internal sale, offering for sale, purchase, transportation, distribution or use of products, and internal quantitative regulations requiring the mixture, processing or use of products in specified amounts or proportions, should not be applied to imported or domestic products so as to afford protection to domestic production.

2. The products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products. Moreover, no contracting party shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1.

3. With respect to any existing internal tax which is inconsistent with the provisions of paragraph 2, but which is specifically authorized under a trade agreement, in force on April 10, 1947, in which the import duty on the taxed product is bound against increase, the contracting party imposing the tax shall be free to postpone the application of the provisions of paragraph 2 to such tax until such time as it can obtain release from the obligations of such trade agreement in order to permit the increase of such duty to the extent necessary to compensate for the elimination of the protective element of the tax.

4. The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use. The provisions of this paragraph shall not prevent the application of differential internal transportation charges which are based exclusively on the economic operation of the means of transport and not on the nationality of the product.

5. No contracting party shall establish or maintain any internal quantitative regulation relating to the mixture, processing or use of products in specified amounts or proportions which requires, directly or indirectly, that any specified amount or proportion of any product which is the subject of the regulation must be supplied from domestic sources. Moreover, no contracting party shall otherwise apply internal quantitative regulations in a manner contrary to the principles set forth in paragraph 1.
6. The provisions of paragraph 5 shall not apply to any internal quantitative regulation in force in the territory of any contracting party on July 1, 1939, April 10, 1947, or March 24, 1948, at the option of that contracting party; Provided that any such regulation which is contrary to the provisions of paragraph 5 shall not be modified to the detriment of imports and shall be treated as a customs duty for the purpose of negotiation.

7. No internal quantitative regulation relating to the mixture, processing or use of products in specified amounts or proportions shall be applied in such a manner as to allocate any such amount or proportion among external sources of supply.

8. (a) The provisions of this Article shall not apply to laws, regulations or requirements governing the procurement by governmental agencies of products purchased for governmental purposes and not with a view to commercial resale or with a view to use in the production of goods for commercial sale.

(b) The provisions of this Article shall not prevent the payment of subsidies exclusively to domestic producers, including payments to domestic producers derived from the proceeds of internal taxes or charges applied consistently with the provisions of this Article and subsidies effected through governmental purchases of domestic products.

9. The contracting parties recognize that internal maximum price control measures, even though conforming to the other provisions of this Article, can have effects prejudicial to the interests of contracting parties supplying imported products. Accordingly, contracting parties applying such measures shall take account of the interests of exporting contracting parties with a view to avoiding to the fullest practicable extent such prejudicial effects.

10. The provisions of this Article shall not prevent any contracting party from establishing or maintaining internal quantitative regulations relating to exposed cinematograph films and meeting the requirements of Article IV.
Appendix IV

Enterprise Income Tax Law of the People's Republic of China

(Adopted at the 5th Session of the 10th National People's Congress of the P. R. of China on March 16, 2007)

Chapter I General Rules

Chapter II Taxable Income Amount

Chapter III Payable Tax Amount

Chapter IV Preferential Tax Treatments

Chapter V Withholding by Sources

Chapter VI Special Adjustments to Tax Payments

Chapter VII Administration of Tax Levy

Chapter VIII Supplementary Rules

Chapter I General Rules

Article 1 The enterprises and other organizations which have incomes (hereinafter referred to as the enterprises) within the territory of the People's Republic of China shall be payers of the enterprise income tax and shall pay their enterprise income taxes according to the present Law. The sole individual proprietorship enterprises and partnership enterprises are not governed by the present law.
Article 2 Enterprises are classified into resident and non-resident enterprises. The term "resident enterprise" as mentioned in the present Law means an enterprise which is set up under Chinese law within the territory of China, or set up under the law of a foreign country (region) but whose actual management organ is within the territory of China. The term "non-resident enterprise" as mentioned in the present Law means an enterprise which is set up under the law of a foreign country (region) and whose actual management organ is not within the territory of China but who has organs or establishments within the territory of China, or who does not have any organ or establishment within the territory of China but who has incomes sourced in China.

Article 3 For its incomes sourced from both inside and outside the territory of China, a resident enterprise shall pay the enterprise income tax. In case a non-resident enterprise sets up an organ or establishment within the territory of China, it shall pay enterprise income tax on its incomes sourced inside the territory of China and incomes sourced outside the territory of China but actually connected with the said organ or establishment. In case a non-resident enterprise has no organ or establishment within the territory of China, or its incomes have no actual connection to its organ or establishment inside the territory of China, it shall pay enterprise income tax on the incomes sourced inside the territory of China.

Article 4 The enterprise income tax shall be levied at the rate of 25per cent. In case a non-resident enterprise obtains incomes as mentioned in Paragraph 3, Article 3 of the present Law, the tax rate shall be 20per cent.

Chapter II Taxable Income Amount

Article 5 The balance after the tax-free and tax-exempt incomes, each deduction item as well as the permitted remedies for losses of the previous year(s) being deducted from an enterprise's total income amount of each tax year shall be the taxable income amount.
Article 6 An enterprise's total income amount refers to the monetary and non-monetary incomes from various sources and includes: (1) income from selling goods; (2) income from providing labor services; (3) income from transferring property; (4) equity investment gains, such as dividend, bonus; (5) interest incomes; (6) rental income; (7) royalty income; (8) income from accepting donations; and (9) other incomes.

Article 7 The tax-free income refers to the following incomes which are included in the total income amount: (1) The treasury appropriations; (2) The administrative fees and the governmental funds which are levied in accordance with the law and fall under the treasury administration; and (3) Other tax-free incomes as prescribed by the State Council.

Article 8 When calculating the taxable income amount, the reasonable expenditures which actually happened and have actual connection with the business operations of an enterprise, including the costs, expenditures, taxes, losses, etc. may be deducted.

Article 9 As regards an enterprise's expenditures for public welfare donations, the portion within 12 per cent of the total annual profits is permitted to be deducted.

Article 10 When calculating the taxable income amount, none of the following expenditures may be deducted: (1) Such equity investment gains as dividend, bonus paid to the investors; (2) Payment for enterprise income tax; (3) Late fee for taxes; (4) Pecuniary punishment, fines, and losses of confiscated properties; (5) Expenditures for donations other than those prescribed in Article 9; (6) Sponsorship expenditures; (7) Unverified reserve expenditures; (8) Other expenditures in no relation to the obtainment of revenues;
Article 11 An enterprise's depreciations of fixed assets, which are calculated pursuant to the related provisions, are permitted to be deducted in the calculation of the taxable income amount. As regards any of the following fixed assets, no depreciation may be calculated for deduction: (1) The fixed assets which have not yet been put into use, among which houses and buildings are not included; (2) The fixed assets which are rented in through commercial lease; (3) The fixed assets which are rented out through finance leasing; (4) The fixed assets for which depreciation has been fully allocated but which are still in use; (5) The fixed assets in no relation to the business operations; (6) The land which is separately evaluated and entered into account as an item of fixed asset; and (7) Other fixed assets for which no depreciation may be calculated for deduction.

Article 12 An enterprise is allowed to deduct the amortized expenditures of intangible assets calculated under the related provisions when calculating the taxable amount of incomes. For the following intangible assets, no amortized expense may be calculated: (1) The intangible assets, which are developed by the enterprise itself and the expenditures have been deducted when calculating the taxable income amount; (2) The self-created business reputation; (3) The intangible assets in no relation to the business operations; and (4) Other intangible assets for which no amortized expense may be calculated for deduction.

Article 13 The following expenditures incurred by an enterprise shall be deemed as long-term deferred expenditures when calculating the taxable income amount. Those amortized pursuant to the related provisions are permitted to be deducted: (1) The expenditures for rebuilding a fixed asset, for which depreciation has been fully allocated; (2) The expenditures for rebuilding a rented fixed asset; (3) The expenditures for heavily repairing a fixed asset; and (4) Other expenditures which shall be deemed as long-term deferred expenditures.
Article 14 When calculating the taxable income amount, an enterprise may not deduct the costs of the investment assets during the period of external investment.

Article 15 In case an enterprise uses or sells its inventories, it is permitted to deduct the costs of the inventories calculated pursuant to the related provisions when calculating the taxable income amount.

Article 16 In case an enterprise transfers an asset, it is permitted to deduct the net value of the asset when calculating the taxable income amount.

Article 17 An enterprise may not offset the losses of its overseas business organs against the profits of its domestic business organs in the consolidated calculation of its enterprise income taxes.

Article 18 The losses suffered by an enterprise during a tax year may be carried forward and made up by the incomes during subsequent years, however, the carry-forward period may not exceed 5 years.

Article 19 In case a non-resident enterprise obtains incomes as prescribed in Paragraph 3, Article 3 of the present Law, the following approaches shall be adopted in calculation of its the taxable income amount: (1) As regards dividends, bonuses and other equity investment gains, interests, rentals and royalties, the taxable income amount shall be the total income amount; (2) As regards incomes from assigning property, the taxable income amount shall be the balance of the total income amount less the net value of the property; and (3) As regards other incomes, the taxable income amount shall be calculated according to the approaches as mentioned in the preceding two items by analogy.
Article 20 The specific scope and standards of revenues and deductions, as well as the concrete tax treatment methods of assets as prescribed in this Chapter shall be constituted by the treasury and tax administrative departments under the State Council.

Article 21 If the enterprise's financial or accounting treatment method does not comply with any tax law or administrative regulation when calculating the taxable income amount, the tax law or administrative regulation shall prevail.

Chapter III Payable Tax Amount

Article 22 The payable tax amount shall be the balance of the taxable amount multiplied by the applicable tax rate minus the tax amounts deducted and exempted as prescribed in the present Law.

Article 23 In case an enterprise has already paid overseas the enterprise tax for the following incomes, it may deduct it from the payable tax amount of the current period. The limit of tax credit shall be the payable tax amount on such incomes calculated under the present Law. The part exceeding the limit of tax credit may, during the five subsequent years, be offset from the balance of the limit of tax credit of each year minus the tax amount which ought to be offset in the current year: (1) A resident enterprise's taxable incomes sourced from outside the territory of China; and (2) Taxable incomes obtained outside the territory of China by a non-resident enterprise having organs or establishments inside the territory of China, but having actual connection with such organs or establishments.

Article 24 As regards the dividends, bonuses and other equity investment gains earned outside the territory of China by a resident enterprise from a foreign enterprise which it controls directly or indirectly, the portion of income tax on this income paid outside the territory of China by the foreign enterprise the territory of China may be treated as the allowable tax credit of the resident enterprise's overseas income tax amount and be deducted within the limit of tax credit as provided for in Article 23 of the present Law.
Chapter IV Preferential Tax Treatments

Article 25 The important industries and projects whose development is supported and encouraged by the state shall enjoy the preferential treatments in enterprise income tax.

Article 26 An enterprise's following incomes of shall be tax-free ones: (1) The interest incomes from treasury bonds; (2) Dividends, bonuses and other equity investment gains generated between qualified resident enterprises; (3) Dividends, bonuses and other equity investment gains which are obtained from a resident enterprise by a non-resident enterprise with organs or establishments inside the territory of China and have actual connection with such organs or establishments; and (4) Incomes of qualified not-for-profit organizations.

Article 27 As regards the following incomes, the enterprise income tax may be exempted or reduced: (1) The incomes generated from the engagement in agriculture, forestry, husbandry and fishery; (2) The incomes generated from investment in and business operations of the important public infrastructure projects supported by the state; (3) The income generated from the projects of environmental protection, energy and water saving and satisfying the related requirements; (4) The incomes generated from transferring technologies and satisfying the related requirements; and (5) The income as provided for in Paragraph 3, Article 3 of the present Law.

Article 28 As regards a small meagre-profit enterprise satisfying the prescribed conditions, the enterprise income tax shall be levied at a reduced tax rate of 20 per cent. As regards important high-tech enterprises necessary to be supported by the state, the enterprise income tax shall be levied at the reduced tax rate of 15 per cent.
Article 29 The autonomous organ of an autonomous region of ethnic minorities may determine to reduce or exempt the enterprise income tax by enterprises within the said autonomous region. In case the decision on deduction or exemption is made by an autonomous prefecture or county, it shall be reported to the people's government of the province, autonomous region, or municipality directly under the Central Government for approval.

Article 30 An enterprise may additionally calculate and deduct the following expenditures in the calculation of the taxable income amount: (1) The expenditures for researching and developing new technologies, new products and new techniques; and (2) The wages paid to the disabled employees or other employees encouraged to hire by the State.

Article 31 In case a startup investment enterprise engages in important startup investments necessary to be supported and encouraged by the state, it may deduct a certain proportion of the investment amount from the taxable income amount.

Article 32 In case an enterprise surely needs to accelerate the depreciation of any fixed asset by virtue of technological progress or for any other reason, it may curtail the term of depreciation or adopt a method for accelerated depreciation.

Article 33 As regards the incomes earned by an enterprise from producing products complying with the industrial policies of the state by comprehensively utilizing resources, the income may be downsized in the calculation of the amount of taxable incomes.
Article 34 As regards the amount of an enterprise's investment in purchasing special equipment for protecting environment, saving energy and water, work safety, etc., the tax amount may be deducted at a certain rate. Article 35 The specific measures for the preferential tax treatments as referred to in the present Law shall be constituted by the State Council.

Article 36 The State Council may constitute special preferential policies on the enterprise income tax in case the national economic and social development so requires, or the business operations of enterprises have been seriously affected by emergencies and other factors, and submit them to the Standing Committee of the National People's Congress for archival filling.

Chapter V Withholding by Sources

Article 37 The payable income taxes on the incomes obtained by a non-resident enterprise as prescribed in Paragraph 3, Article 3 of the present Law shall be withheld by sources, with the payer acting as the obligatory withholder, who shall withhold the tax amount from each payment or payment due.

Article 38 As regards the payable income taxes on the incomes obtained by a non-resident enterprise within the territory of China from undertaking engineering projects or providing labor services, the payer of the project price or remuneration may be designated as the obligatory withholder by the tax organ.

Article 39 In case the obligatory withholder has failed to withhold the income tax which ought to be withheld according to Articles 37 and 38 of the present Law or is unable to perform the withholding obligation, the taxpayer shall pay them at the place where the income has occurred. In case the taxpayer fails to do so, the tax organ may recover the payable tax of the enterprise from its other income items within the territory of China which ought to be paid by the payer.
Article 40 A obligatory withholder shall, within 7 days after the date of withholding, turn over to the state treasury the tax payments which it withholds every time and submit a form of report on the withheld enterprise income taxes to the local tax organ.

Chapter VI Special Adjustments to Tax Payments

Article 41 As regards a transaction between an enterprise and its affiliated parties, in case the taxable revenue or income of the enterprise or its affiliated parties reduces by virtue of the failure to conform to the arms length principle, the tax organ may, through a reasonable method, make an adjustment. As regards the costs of an enterprise and its affiliated parties for jointly developing or accepting intangible assets, or jointly providing or accepting labor services, they shall, when calculating the taxable income amount, apportion them according to the arms length principle.

Article 42 An enterprise may propose the pricing principles and calculation methods for the transactions between it and its affiliated parties to the tax organ, the tax organ and the enterprise shall, upon negotiations and confirmation, achieve an advance pricing arrangement.

Article 43 When an enterprise submits its annual enterprise income tax returns to the tax organ, an annual report on the affiliated transactions between it and its affiliated parties shall be attached. When the tax organ investigates into the affiliated transactions, the enterprise and its affiliated parties, as well as other enterprises in relation to the affiliated transactions under investigation, shall, according to the related provisions, provide the related materials.

Article 44 In case any enterprise refuses to submit the materials on transactions which happened between it and its affiliated parties, or provides any false or incomplete material, on the basis of which the true information about the affiliated transactions cannot be reflected, the tax organ may determine upon check its taxable income amount.
Article 45 As regards an enterprise which is set up in a country (region) where the actual tax burden is apparently lower than the tax rate as prescribed in Paragraph 1 of Article 4 of the present Law by a resident enterprise or controlled by an resident enterprise or by a Chinese resident, in case it fails to distribute the profits or decreases the distribution not by virtue of reasonable business operations, the portion of the aforesaid profits attributable to this resident enterprise shall be included in its incomes of the current period.

Article 46 As regards an enterprise's interest expenditures for any credit investments and equity investments accepted from its affiliated parties, in excess of the prescribed criterion, the enterprise may not deduct them when calculating the taxable income amount.

Article 47 In case an enterprise makes any other arrangement not for any reasonable commercial purpose, which causes the decrease of its taxable revenue or income, the tax organ may, through a reasonable method, make an adjustment.

Article 48 In case the tax organ makes an adjustment to a tax payment pursuant to the provisions in this Chapter so that it is necessary to recover the tax payment in arrears, it shall do so and charge an additional interest according to the provisions of the State Council.

Chapter VII Administration of Tax Levy

Article 49 The administration for levying enterprise income taxes shall be subject to the Law of the People's Republic of China on Administering Tax Levy in addition to the present Law.
Article 50 The tax payment place of a resident enterprise shall be its registration place unless it is otherwise provided for in any tax law or administrative regulation. But in case its registration place is outside the territory of China, the tax payment place shall be the place at the locality of its actual management organ. As regards a resident enterprise which has set up operational organs without legal person status inside the territory of China, it shall, on a consolidated basis, calculate and pay its enterprise income taxes.

Article 51 In case a non-resident enterprise earns any income as prescribed in Paragraph 2, Article 3 of the present Law, the tax payment place shall be the place at the locality of the organ or establishment. In case a non-resident enterprise has set up two or more organs or establishments within the territory of China, it may choose to have its main organ or establishment make a consolidated payment of the enterprise income tax upon the examination and approval of the tax organ. As regards a non-resident enterprise which earns any income as prescribed in Paragraph 3, Article 3 of the present Law, the place at the locality of the obligatory withholder shall be the tax payment place.

Article 52 Enterprises may not pay their enterprise income taxes on a consolidated basis unless it is otherwise prescribed by the State Council.

Article 53 Enterprise income taxes shall be calculated on the basis of a tax year, which is from January 1 to December 31 of the Gregorian calendar year. In case an enterprise's business operations are started or terminated in the middle of a tax year, which leads to its actual business operation period in this tax year being shorter than 12 months, its actual business operation period shall constitute a tax year. When an enterprise is under liquidation according to law, the liquidation period shall be a tax year.
Article 54 Enterprise income taxes shall, on the monthly or quarterly basis, be paid in advance. An enterprise shall submit an enterprise income tax return for advance payment to the tax organ and pay the tax in advance within 15 days after the end of a month or quarter. An enterprise shall submit an annual enterprise income tax return for the settlement of tax payments to the tax organ and settle the payable or refundable amount of taxes within 5 months after the end of each year. When an enterprise submits an enterprise income tax return, the financial statements and other related materials shall be attached in accordance with the related provisions.

Article 55 In case an enterprise terminates its business operation in the middle of a year, it shall apply to the tax organ for calculating and paying the enterprise income taxes of the current period within 60 days after the actual date for terminating its business operations. Before the deregistration formalities are handled, an enterprise shall make a declaration to the tax organ and pay the enterprise income taxes on the basis of the income of the liquidation.

Article 56 Enterprise income taxes to be paid pursuant to the present law shall be calculated on the basis of RMB. In case any income is calculated on the basis of a currency other than RMB, the taxes shall, after such income converted into RMB, be calculated and paid.

Chapter VIII Supplementary Rules

Article 57 In case an enterprise has already been set up before the promulgation of the present Law and enjoys low tax rates in accordance with the provisions of the tax laws and administrative regulations in force at that time, it may, in accordance with the provisions of the State Council, continue to enjoy the preferential treatments within five years as of the promulgation of the present Law and gradually transfer to the tax rate as prescribed in the present Law. In case an enterprise enjoys the preferential treatment of tax exemption for a fixed term, it may, after the promulgation
of this Law, continue to enjoy such treatment in accordance with the provisions of the State Council until the fixed term expires. However, if an enterprise has failed to enjoy the preferential treatment by virtue of failure to make profits, the term of preferential treatment may be counted as of the year when the present Law is promulgated. As regards high-tech enterprises which are newly established with the key support of the State within the particular areas set up by law for developing foreign economic cooperation and technological exchanges or the areas enjoying the abovementioned special policies as provided for by the State Council, they may enjoy transitional preferential tax treatments. The specific measures thereof shall be constituted by the State Council. As regards other enterprises falling within the encouraged category as already determined by the State Council, they may, according to the provisions of the State Council, enjoy the preferential treatment of tax reduction or exemption.

Article 58 In case any provision in a tax treaty concluded between the government of the People's Republic of China and a foreign government is different from the provisions in the present Law, the provision in the said treaty shall prevail.

Article 59 The State Council shall constitute a regulation for implementing the present Law.

Article 60 The present law shall go into effect as of January 1, 2008. The Income Tax Law of the People's Republic of China Concerning Foreign-funded Enterprises and Foreign Enterprises as adopted on April 9, 1991 at the 4th Session of the Standing Committee of the 7th National People's Congress and the Interim Regulation of the People's Republic of China Concerning Enterprise Income Tax as promulgated on December 13, 1993 by the State Council shall be concurrently abolished.