

Challenge? Opportunity!

China and Hong Kong Tax Update – A Summary

China Tax Update

The New China Corporate Income Tax (CIT) Law was approved by the National People's Congress and promulgated on 16 March 2007 and will become effective on 1 January 2008. Like previous income tax laws, the CIT law mainly provides the mainframe tax provisions. The release of detailed implementation rules is expected in fall 2007.

Summary of key aspects of the CIT law

- **Tax Resident Enterprise (TRE) concept**
A foreign enterprise with “effective management” in China will be regarded as a TRE and subject to CIT on its worldwide income.
- **Tax rate**
The new rate is 25%. Lower rates of 20% and 15% are also available for qualified small/thin-profit companies and qualified high/new technological enterprises without geographical limitation respectively. In addition, the withholding tax rate on dividend, interest, royalty or other passive income derived by foreign companies is 20% under the CIT law.
- **New tax incentive policy**
The existing tax holidays generally applicable to production nature foreign investment enterprises will be cancelled. Under CIT law, tax incentives will be offered with industry focus, such as enterprises engaged in technological development, environment protection, energy conservation and production safety.
- **Grandfathering**
Unexpired tax holidays can continue to be utilised by qualified foreign investment enterprises set up prior to 16 March 2007. Tax holidays yet started will be deemed to commence from 2008. In addition, if old enterprises enjoy a reduced tax rate due to their locations, there will be a five-year transition period, under which the income tax rate will be increased gradually to the new rate at 25%.
- **Anti-avoidance**
The CIT law also introduces Anti-avoidance, Controlled Foreign Corporation, Thin-capitalisation and more stringent Transfer Pricing regulations.

Hong Kong Tax Update

In view of the relocation of sales, purchase and/or managerial/administration functions to China, Hong Kong investors may risk being regarded as having a permanent establishment in China. A State

Administration of Taxation ruling in late 2006 confirmed this view. Therefore, it is suggested that Hong Kong investors review their operational models with a view to identifying such exposure.

Secondly, Hong Kong Board of Review case D43/06 was released, under which the taxpayer has “tentatively” obtained a 50/50 manufacturing claim on its import processing arrangement. While the Inland Revenue Department (IRD) will appeal the case to the court, the future implications of this case are still uncertain.

Transfer Pricing

The Costs Sharing Arrangement and special interest levy on tax adjustments concepts have also been introduced in the CIT law. Contemporaneous transfer pricing documentation may soon be required.

Field Audit and Investigation

The IRD has continuously deployed more resources in field audit and investigation. Tax matters involving inter-company transactions, offshore claim and transfer pricing become the IRD’s target in selecting cases. Taxpayers must be able to show, in both form and substance, commercial and technical justifications. Recent experience has indicated that it has become more difficult to resolve cases (including penalty) on a compromise basis. Nevertheless, an internationally recognised transfer pricing methodology appears to be a key to settlement in the future.

Conclusion

It is suggested that taxpayers acquire a thorough understanding of existing business operations as well as the underlying tax risks involved before considering any tax planning opportunities. Operation reviews are usually conducted to serve such purposes. On the other hand, taxpayers can consider applying for an advance ruling provided by tax authorities to ensure the feasibility of each arrangement. This can effectively avoid potential disputes with tax authorities in future.

In view of the tightening measures of tax authorities, taking action in advance is crucial in preparing for emerging challenges and opportunities.

(The information contained in this article is for general guidance on matters of interest only. The application and impact of laws can vary widely based on the specific facts involved. Before taking any action, please ensure that you obtain advice specific to your circumstances from your usual accountants/advisers.)