



# China Insights

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## More on China's New Tax Law

In our October/November 2007 issue of *China Insights*, we summarized some basic changes in China's new Enterprise Tax Law (the New Tax Law) which was adopted on March 16, 2007 (the Adoption Date), and became effective on January 1, 2008 (the Effective Date). The first Implementation Regulations for the New Tax Law (the Implementation Regulations) were adopted on December 6, 2007. Although the Implementation Regulations provide some clarifications (and some commentators say, modifications) to the New Tax Law, they do not address all of the unanswered questions raised in the New Tax Law. This article discusses some of the most important of these clarifications and modifications as well as some additional governmental guidance and some of the practices that are expected to result.

### Transition Period for Grandfathering Treatment

The New Tax Law generally provides for the cessation of tax exemptions for foreign invested enterprises (FIEs), effectively fully equalizing the enterprise income tax playing field for all enterprises—whether domestic or international—by the year 2013. With that said, the New Tax Law provides grandfathering treatment to FIEs in existence prior to the Adoption Date. However, neither the New Tax Law nor the Implementation Regulations addressed completely the way in which this grandfathering treatment is supposed to work. Somewhat more complete

guidance was provided by China's State Council just before the end of 2007 in a circular addressing grandfathering treatment available to "old" FIEs (Circular 39). In Circular 39, the State Council clarified that the New Tax Law applies to all enterprises that were formed after the Adoption Date. The formation of the enterprise is defined as the date when it obtained its Business License. Over the five years immediately following the Effective Date, FIEs that enjoyed the 15% preferential tax rate before the Adoption Date will see their tax rates annually increase to 18% in 2009, 22% in 2010, 24% in 2011 and 25% in 2012. Further, on February 20, 2008, the Ministry of Finance (MOF) and the State Administration of Taxation (SAT) jointly issued No. 21 Circular (Circular 21) clarifying that rates applicable to FIEs enjoying a 50% reduction of the above rates (see discussion on **Tax Incentives** below) will be 9% in 2009, 11% in 2010, 12% in 2011 and 12.5% in 2012 and beyond. FIEs that enjoyed a 2-year zero tax rate and a 3-year 50% tax rate and those that enjoyed a 5-year zero tax rate and a 5-year 50% tax rate or for some other specified period will continue their tax holiday as given. It should be noted, however, that all of these previously granted tax holidays commenced with the first year in which the FIE had a profit, and it is now clear that the New Tax Law deems 2008 to be considered an FIE's first profit-making year (whether or not it is actually profitable).

### Tax Incentives

Tax exemptions and lower tax rates will continue to be given (and in some cases, begin to be given) in connection with investments in specific geographic areas or with respect to particular industries in which the Chinese government decides to continue or to establish incentives for such investments. For example, the New Tax Law provides that investments in infrastructure, environmental protection, and energy or water conservation projects will have a 3-year tax exemption and a 3-year 50% tax reduction in order to continue the promotion of growth and development in these areas. The most notable provisions, however, relate to so-called High/New Technology Enterprises (HNTEs). The Implementation Regulations clarify the scope of the new tax incentives offered to HNTEs. Also, shortly after the promulgation of the Implementation Regulations, the State Council issued yet another tax

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circular clarifying tax benefit treatment available to high technology enterprises set forth in certain Special Economic Zones and Pudong (Circular 40). Under

the Implementation Regulations and Circular 40, the tax benefit that an HNTE enjoys include: (i) a reduced tax rate of 15% as compared to the standard rate of 25%; (ii) a

withholding tax exemption on dividends by HNTEs to their foreign shareholders; (iii) HNTEs newly set up in certain Special Economic Zones and Pudong can enjoy tax holidays, which include 2-year exemptions and 3-year 50% (of 25%) tax reduction, with the holiday commencing from the first income-generating year. To qualify as an HNTE, an entity must meet the statutory requirements, which include, among others, having its core intellectual property (IP) classified as falling within specific high-tech industry categories as well as meeting certain other requirements relating to research expenditures, high-tech related revenues and scientific personnel staffing and recruitment. The detailed measures required to be met in order to certify an HNTE are still in the draft stage and not yet released.

The tax incentives offered to HNTEs reflect China's desire to transition parts of its economy from manufacturing to invention-oriented. These incentives are clearly intended as incentives for foreign companies to transfer some of their more sophisticated technology and R&D activities to their China-based

affiliates—something that many of these companies have been reluctant to do in large part because of their concerns about IP protection in China. At

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present, the common practice is for foreign affiliates of China-based companies to use license arrangements to allow the latter to use certain technology while ownership of the

licensed technology continues to be controlled by the foreign affiliate. Such license arrangements will not, however, meet the IP ownership requirements that must be met in order to be classified as an HNTE. If tax saving is really a driving force for certain foreign investors, then such investors will need to transfer their IP rights to their Chinese affiliates or co-develop certain technology through a cost-sharing arrangement.

It should be noted that the criteria for obtaining HNTE status set forth in the Implementation Regulations are much higher than were the criteria for being classified as a high-tech enterprise prior to the Adoption Date in order to qualify for preferential tax treatment. As such, existing high-tech enterprises will not necessarily meet the IP ownership requirements required in order to qualify for HNTE status. Also, a certified HNTE will be subject to ongoing annual inspections as well as unannounced, random inspections, and if the inspected HNTE is not deemed to be continually qualified, the tax benefit it enjoys will be suspended.

### Residential Enterprises

The Implementation Regulations address a new qualification that broadens the scope of business enterprises considered to be "residential." A residential enterprise is subject to Chinese tax on its worldwide income and is allowed to credit its foreign income tax paid on foreign-sourced income. "Residential Enterprises" include not only those that are registered in China, but also those that have their places of effective management within China. "Effective management" has been defined as an established enterprise that exercises control over areas, in China, including without limitation, management, production, personnel and accounting. The emphasis on "effective management" focuses on the location of operations and day-to-day decision making as opposed to the location of board meetings. This would include enterprises that may have been previously exempt because their executive meetings or other similar managerial activities were held outside of China. Multinational corporations with their Asia/Pacific headquarters in China are likely to be classified as being effectively managed in China.

In addition, the New Tax Law provides that nonresidential enterprises will be liable for taxes, at a 20% rate, on income derived from China. The Implementation Regulations have lowered this rate to 10%, but have included any income derived from China, even when it is not connected to any establishment in China. Sources of taxable income include dividends, interest, royalties and rent, among other things.

## Transfer Pricing Enforcement

Under the New Tax Law, Chinese tax authorities are authorized to apply reasonable methods to adjust an FIE's income if the FIE and its affiliates do not comply with the principle that pricing between affiliates should be determined on an arm's length basis. The Implementation Regulations list various methods as reasonable for determining appropriate pricing, including the comparable uncontrolled price method, the resale price method, the cost plus method, the transactional net margin method, the profit split method and other methods that satisfy the arm's length principle. The Implementation Regulations also require taxpayers to provide documentation to support the application of whatever pricing method has been utilized.

## Anti-tax Avoidance

As reported in our October/November issue, the New Tax Law introduced the "thin-capitalization" rule pursuant to which an interest expense deduction is not allowed if it relates to a debt that exceeds a specified related party debt-to-equity ratio. Neither the New Tax Law nor the Implementation Regulations specify the debt-equity ratio, and it still remains to be specified. As also reported in our October/November Issue, before the effective date of the New Tax Law, an FIE's capital structure must comply with the statutory debt-to-equity ratio, and payment of interest on debt in excess of this ratio is not allowed. However, there is no similar requirement imposed on domestic enterprises. Therefore, this specific anti-tax avoidance rule may have more impact on domestic enterprises than FIEs if the to-be-issued new

debt-to-equity ratio is no more stringent than the current debt-to-equity ratio applicable to an FIE's capital structure.

## Withholding Tax

As reported in our last issue of *China Insights*, before the New Tax Law, dividends paid by an FIE to its foreign shareholder were exempted from withholding requirements. This has been changed by the New Tax Law, which provides for a 20% withholding

requirement on dividends. The Implementation Regulations reduced this rate to 10%.

By way of further clarification, on February 22, 2008, the MOF and SAT jointly issued a circular stating that any distribution of earnings accumulated prior to 2008 will be exempted from withholding tax. In all events, tax on dividends paid by FIEs to foreign shareholders will increase overall compared to what they were prior to the New Tax Law. In light of this and other provisions of the New Tax Law, establishing a tax-efficient holding company structure for an FIE requires an analysis of the impact of China's tax treaties with various jurisdictions—especially jurisdictions commonly known as low or no tax havens.

## Tax-free Restructuring

As reported in our last issue of *China Insights*, the New Tax Law seemed to indicate that the tax-free restructuring safe harbor that existed prior to the Effective Date may no longer be available when the New Tax Law went into effect. This view remains unchanged under the Implementation Regulations. The Implementation Regulations provide that companies that

restructure will recognize gains and losses at the time the restructuring transaction takes place unless the Ministry of Finance and the State Administration of Taxation provide other specific relief. To date, a provision providing for such relief has not been adopted.

## Conclusion

The Implementation Regulations have clarified certain aspects of the New Tax Law, but further governmental

pronouncements are expected. In the meantime, as is always the case with new laws and regulations adopted

in China, the extent and character of the enforcement of the New Tax Law and the Implementation Regulations during the weeks and months immediately following their adoption will likely differ from the enforcement that can be expected in the long-term, after more governmental guidance and experience. Also, less developed cities in China may not be as prompt to adopt the New Tax Law and the Implementation Regulations as larger ones. It is certain that more issues will arise and further clarifications will be needed. We plan to provide additional updates in future issues of *China Insights*.

Please contact either Allan Goldner at (216) 363-4623 or [agoldner@bfca.com](mailto:agoldner@bfca.com) or Yanping Wang at (216) 363-4664 in the U.S., (86) 21-3222-0388 in China, or [ywang@bfca.com](mailto:ywang@bfca.com) with any questions or comments. Serena Hsieh, a Boston University student who interned with our Benesch Shanghai Office, co-authored and was a significant contributor to this article.



## Updates on China's Labor Legislation

Following the adoption of The Labor Contract Law and The Law on Employment Promotion in 2007 (which we discussed in detail in the October/November 2007 issue of *China Insights*), a series of new laws and regulations concerning labor relations was issued recently. Among them, The Law on Labor Dispute Mediation and Arbitration (the Labor Dispute Law) is an important law aimed at improving China's labor system

by solving labor disputes justly and in a timely manner. Other developments include revised procedures for

national holidays and provisions on paid annual leave that are, from the Chinese government's perspective, intended "to better protect employees' interests and help the Chinese government promote harmonious labor relations."

All enterprises in China—foreign and domestic—need to pay close attention to the changes and new provisions in order to remain in compliance with the law. The following are summaries of these recent developments.

### The Law on Labor Dispute Mediation and Arbitration

The Labor Dispute Law was passed on December 29, 2007, by the 31st Conference of the Standing Committee of the 10th National People's Congress, and will take effect on May 1, 2008. The Labor Dispute Law provides that when a labor dispute arises between an employee and an employer, the employee may negotiate with the employer, or he may invite the applicable labor union or a third party to negotiate with the employer.

If the employee is not willing to negotiate with the employer, if negotiations fail or if the employer fails to honor any agreed-upon resolution, the employee may apply for mediation. If mediation is

requested, the employer must form a labor dispute mediation committee in conjunction with the company's employee representatives. The chair of the committee must either be a representative from the labor union or someone elected by both parties.

If the employee is not willing to enter into mediation with the employer, if the mediation fails to resolve the dispute or if the employer fails to honor the

*"Under the new Labor Dispute Law, employees have one year to file [for arbitration]..."*

agreement reached during mediation, the employee may apply for arbitration. Except in certain circumstances, the employee may file

a lawsuit against the employer if he is not satisfied with the results of the arbitration.

Under the Labor Dispute Law, the time period to complete any labor dispute arbitration has been shortened from 60–90 days to 45–60 days. Currently, employees must file for arbitration within 60 days of the date the dispute arises; however, under the new Labor Dispute Law, employees have one year to file, starting from the date the employee becomes aware of, or should have become aware of, the violation in question.

Disputes involving an enterprise's failure to pay wages are not subject to the one-year claim limitation period if the employment relationship still exists. However, once the employment relationship terminates, employees must file an application within one year. In all events, the arbitration of employment disputes is free of charge.

### Revised Procedures for National Holidays

China's State Council has revised The Procedures for National Holidays for Festivals and Memorial Days (the Procedures). The revised Procedures took effect on January 1, 2008.

The Procedures provide: one day off for New Year's Day, on January 1; three days off for China's Spring Festival, from the eve of the Lunar New Year to the second day of Lunar New Year; one day off for Tomb-Sweeping Day; one day off for Labor Day, on May 1; one day off for the Dragon Boat Festival; one day off for Mid-Autumn Festival; and three days off for National Day, from October 1 to October 3.

The official holiday schedule for the balance of 2008 is:

HOLIDAY	2008 DATES
Tomb-Sweeping Festival . . . . .	April 4
Labor Day. . . . .	May 1
Dragon Boat Festival. . . . .	June 8
Mid-Autumn Festival . . . . .	September 14
National Day. . . . .	October 1, 2 and 3

### Paid Annual Leave

The State Council also issued The Provisions for Employees' Paid Annual Leave (the Provisions), which also took effect on January 1, 2008. The Provisions stipulate that if an employee has worked for more than one year, but less than 10 years, he is entitled to a paid annual leave of five days. If an employee has worked for more than 10 years, but less than 20 years, the paid annual leave will be 10 days; and, if an employee has worked for more than 20 years, the paid annual leave will be 15 days. National holidays are not included in the paid annual leave.

If an employer cannot accommodate an employee's request for annual leave, the employer is required to pay the employee for un-taken leave days at 300% of the regular daily wage rate.

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## Events

### Opportunities in China— Breakfast Briefing

Peter Shelton and Yanping Wang will participate in a panel discussion at this event, which is co-sponsored by Benesch, EdgePoint Capital and Morgan, Evan & Company. Registration and continental breakfast begin at 8:00 am and presentation will follow from 8:45 to 11:30 am.

April 30, 2008 | Cleveland, OH

### China: Transportation To, From and Within

Bob Spira of Benesch's China and Transportation Groups will be a panelist

at the 2008 Transportation Lawyers Association Annual Conference.  
May 9, 2008 | Ft. Lauderdale, FL

### China Legal Update

Yanping Wang, Allan Goldner and Peter Shelton will be the featured speakers at this Cleveland Bar Association International Law Section continuing legal education (CLE) program.  
May 22, 2008 | Cleveland, OH

### Doing Business in China— The Course

Yanping Wang, Peter Shelton and Allan Goldner will teach this course at

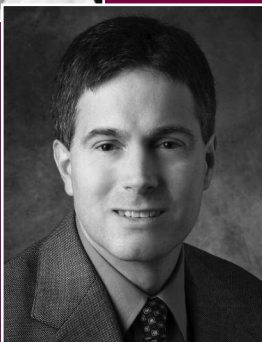
Cleveland State University's Cleveland-Marshall College of Law this spring and summer. The overall objective of the course is to introduce business, cultural and legal aspects of doing business in China. The focus of the course will be on issues involved in direct investment activities and special issues encountered by U.S. companies doing business in China.

### Save the Date! Benesch's October Shanghai Event

Benesch will celebrate the first anniversary of its Shanghai law office. More information to come.  
October 28, 2008 | Shanghai, P.R. China

For more information, please contact  
Lindsay Wise at [lwise@bfca.com](mailto:lwise@bfca.com) or  
(216) 363-4174.

## Kay Zhao Joins China Group, Peter Shelton Moves to Shanghai Office



Kay Zhao joined Benesch's China Group this February as a China Legal Consultant in the firm's Shanghai office. Kay brings to the group valuable experience in providing legal counsel to international investors doing business in China. She is experienced in handling foreign direct investments, mergers and acquisitions, joint ventures, reorganizations of multinational companies in China, and Chinese governmental and regulatory matters.

Kay speaks fluent English in addition to Mandarin, and is well-versed in managing business matters cross-culturally. Kay received her Bachelor of Law from Jilin University and her Masters in Economic Law from Manchester University in England. She is also a candidate for a Ph.D. in Law from Jilin University and has earned a Chinese Nationwide Lawyer Certificate.

Kay joins Shanghai Office Partner-in-Charge Yanping Wang, Of Counsel Leo Pan, and Office Manager and Legal Assistant Joanna Liao. In July, Benesch partner and China Group Co-Chair Peter Shelton will join Kay, Yanping, Leo and the rest of the Shanghai Office staff when Peter and his family relocate from Cleveland to Shanghai.

While in Shanghai, Peter will continue to work with clients making investments in China by way of acquisitions, joint ventures and building greenfield operations. He will also assist clients with other matters pertaining to doing business in China and with Chinese suppliers and customers.

Peter also plans to work with the other members of the Shanghai office to continue expanding and strengthening Benesch's relationships in China with government officials, service providers and business contacts. "With our expanding resources in Shanghai, we intend to continue to help our clients successfully navigate China's legal system and business environment," Peter explained.

Peter and his family are looking forward to relocating to Shanghai and, while there, having the opportunity to travel throughout the country and to learn more about China's rich history and culture.

# Updates on China's Labor Legislation

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## Guangdong, Public Notice Required for Signed Labor Contracts

The Guangdong Province Tentative Procedures for Making Public the Signing of Labor Contracts (the Tentative Procedures) was issued by Guangdong Province's Labor and Social Security Bureau (the Bureau) on October 22, 2007, and took effect the same day.

The Tentative Procedures require employers, within one month after signing labor contracts with employees, to disclose the basic provisions of the labor contracts so that the information is readily accessible to all employees of the enterprise.

The information, including names of employees and the period of the contract, must be presented in a form provided by the Bureau and the form should be made public for at least seven days. Employers are required to keep the forms for at least two years after the termination of relevant labor contracts.

For more information on this topic, please contact Leo Pan at (86) 139-1754-4172 or [lpn@bfca.com](mailto:lpn@bfca.com), or Peter Shelton at (216) 363-4169 or [pshelton@bfca.com](mailto:pshelton@bfca.com).

## How We Work With Clients

We help U.S. companies as they: (1) establish China-related strategic alliances and joint ventures for manufacturing and distribution; (2) establish wholly owned manufacturing or other business operations in China; (3) acquire the shares or assets of China-based companies; (4) deal with governmental and operationally related legal issues in China; (5) source components or products from China and deal with related logistics issues; and (6) develop U.S.-based solutions to competition from China.

We also help Chinese companies with respect to U.S. legal and business considerations as they: (1) establish U.S.-related strategic alliances and joint ventures for manufacturing and distribution; (2) establish subsidiaries and other business operations in the U.S.; and (3) acquire the shares or assets of U.S. companies.

We help clients as they structure, negotiate and document China-related transactions; and consult with clients with respect to capital structure, operating control, governance, due diligence and other issues.

In the area of intellectual property, we are experienced in working with our China-based colleagues and government officials to maximize the protection of our clients' valuable patents, trademarks, know-how, trade secrets and other intellectual property rights.

Our established network of highly competent, experienced and reliable U.S. and China-based service providers (including Chinese licensed lawyers with whom we work when our clients' needs require) enables us to help produce complete China business/legal solutions. Together we provide U.S., China and other international legal, tax, governmental relations, import/export, construction, operational and other solutions for our clients in a cost-effective manner.

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