

March 2007

Mixed feelings over China's new tax system

HONG KONG - Under a law passed by the annual session of the National People's Congress last week, China's long-awaited unification of corporate income tax will come into effect next January 1.

Under the Corporate Income Tax Law, the unified corporate income tax for both domestic and foreign companies is 25%. That means overseas firms will have to pay more than they do now while domestic companies pay less.

At present, foreign investors in China's special economic zones (SEZs), development zones or industrial parks, particularly those in the manufacturing industry, enjoy favorable taxation rates and tax incentives, paying income tax at rates as low as 10%. Foreign-invested businesses outside such special places, and especially those in retail sales, finance and other services, normally have to pay higher income tax up to the standard rate of 33%. Domestic businesses normally pay a standard 33% income-tax rate.

Therefore, domestic companies generally hail the new law, as it will help boost their profitability. But overseas investors have mixed feelings.

The government began to mull unifying corporate income tax almost a decade ago, so many foreign manufacturers on the mainland, including those from Hong Kong, seem to be well prepared for the possible impact of the new law, which will see them paying more tax.

Moreover, despite the tax hike, China, with its growing market and abundant human resources, may remain a major attraction to foreign investment. The fairer and simpler tax system is attractive to foreign companies operating in the country.

Yue Yuen Industrial (Holdings), the world's largest maker of branded sports shoes, including Nike, which has factories in China, Vietnam and Indonesia, now enjoys an average tax rate of only 2%.

An official for the company, which has four plants in Guangdong province in southern China, employing more than 130,000 people, said it's still hard to figure out the possible impact of the new law.

"We can't tell what impact will be put upon us until the authorities have announced all the law details," expected to come out by the end of this year, said the official, who asked not to be named.

But he said abundant human resources, good infrastructure and a huge market are also important factors making it desirable for them to increase their investment in China. The company is now considering setting up a new plant in inland China.

Danny Po, partner at global advisory firm PricewaterhouseCoopers, said Hong Kong services, such as professional and financial, will benefit from the new law.

"As the law is aimed at improving its industrial development by encouraging the services while discouraging the manufacturing sector, the most affected by the law will be the manufacturers, particularly those small and medium-sized enterprises, while the service industry, such as consultancy firms, financial service firms and retailers, will benefit from it," he said.

"But some manufactures now may rush to the mainland to set up their factories before the law comes into effect."

Although the new law will strip away the two-year full tax exemption and three-year partial tax exemption for foreign manufacturers, enterprises currently enjoying low tax rates will continue to have the privilege for a five-year grace period.

"Besides, some manufacturers might increase investment in research and development, in a bid to turn themselves into high technology or environmental protection firms to compete for the new privileges under the new law," Po said.

Under the new law, the 15% tax rate will be applicable to enterprises in the agricultural, environmental-protection, energy-saving and high-tech industries. But he warned that some companies are trying to use "transfer pricing" to get the

privileges of a 20% tax rate, which applies to low-profit firms under the new law.

"Apart from the changes of tax rates, strengthening the implementation of tax law is another main goal of the tax reform, so manufacturers have to be careful in dealing with their accounts," Po said.

Mak Ho-nan, manager of Xinde Electronic in Shenzhen, employing about 350 people, said the firm is looking at the possibility of moving its plant to central China.

"Besides the tax increase, increasing labor costs, stricter environmental-protection rules and the yuan appreciation have become a headache for small and medium enterprises [SMEs] in recent years. Central or western China seems to be a solution to our problems," he said.

The new tax law also stipulates continuing tax breaks for foreign investment in the vast but economically backward western regions, where unemployment is high.

Joseph Liu of China Concord Ltd, a health-care operator in Hong Kong, has different views on the prospects in China after the unification of corporate income-tax rates, saying the higher tax burden compared with Hong Kong will be easily offset by the profits earned in China.

"The company is planning to set up a clinic with four doctors in shopping and entertainment areas in Guangzhou by the end of this year," said Liu.

"When you see the Chinese government is going to spend 31 billion yuan [US\$4 billion] on health care this year, and the number of fake-drug cases [that have come to light], as well as how poor the existing health care in China is, you know the demand for health care is unprecedented and so are the profits," he said.

According to his estimates, the profits not only come from clinic fees, but also comprehensive checkups, including blood tests, X-rays and medical imaging services, etc.

"We believe Hong Kong's health-care operation is a promising business in China,

given its world-class medical service," he said.

Man Law, head of the Greater China division of Conpak Cpa Ltd, which offers corporate registration and one-stop business service in China, said it is going to open new offices in Shanghai and Beijing in the future.

"The tax rate, to be reduced to 25% from 33%, has a positive impact on our expansion plan, and the most important is the cities like Shanghai that have many foreign companies, which are our target customers, and the demand for business service there has been very strong," Law said.

Although the impact of the tax reform will vary depending on the type of industry and its location, it will definitely affect the privileged status and competitive advantages long enjoyed by SEZs in China.

Chan Yan-chong, director of the master of business administration program at City University of Hong Kong, said the passage of the new law has signified the end of the historical mission of SEZs.

"To attract foreign investment to help develop underdeveloped China more than 25 years ago, the favorable taxation terms offered at that time were necessary. Now that the Chinese economy is rising by about 10% a year and the country's tax revenue is growing at a double-digit rate, the time to change the old tax system is ripe. But once the comparatively low tax rates offered by SEZs are scrapped, their mission of opening up the country to the outside world has been completed," he said.

However, Chan said the scrapping of favorable treatment for foreign investors in the SEZs will have a positive impact on the relationship between Shenzhen and its closest neighbor, Hong Kong.

"Shenzhen, after being stripped off the privileges it offers now, will be in danger of marginalization, so it's high time for the city to get closer to its neighbor to perform complementary roles, which will be good for both cities," he said.

Beijing designated four SEZs to offer preferential policies to advance its market-oriented reforms in 1980. They were Shenzhen, Xiamen, Shantou and Zhuhai. It

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designated Pudong in Shanghai an SEZ in 1990.

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