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FORETHOUGHT TAX INCENTIVES

Tapping Hidden Opportunities in China's New Tax Law

by Jeff Olin and Gary James

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A new Chinese law has erased many of the previous tax benefits for foreign firms, but it also offers abundant opportunities for multinationals that are willing to help transform the country into a more sophisticated—and greener—producer of high-end goods.

For many foreign firms, the law, which took effect this year, will inevitably increase the cost of doing business in China. It sets a single corporate income tax rate of 25% for all foreign and domestic companies—low by other countries' standards (the U.S. rate is 35%, for example) but a shock to the system for the many firms that have been paying deeply discounted rates. For those companies, the law will have the effect of increasing taxes by up to 25% over the next five years. In addition, China will place multinationals under greater scrutiny as it seeks to ensure that it's getting its share of the wealth generated by the country's economic boom.

The new tax regulations also form a map, of sorts, showing how the Chinese authorities plan to transform the country: China wants to improve its transport infrastructure. It is looking for more high-tech jobs for its engineers. It wants to green its industry. And it hopes to dispel its image as a manufacturer of cheap products and become a provider of high-quality, high-margin goods.

The country is providing tax incentives to make all this happen. Of course, the authorities may tweak the rules for months to come—there's no telling what exact shape the regulations will eventually take. It's crucial for firms wishing to benefit by assisting in the transition to be sure they're relying on the most up-to-date official guidelines.

That said, here are a few general things multinationals can do to take advantage of the tax breaks. Some may require a willingness to diversify or alter operations in China.

Do research. Some of the biggest tax breaks have been reserved for multinationals engaged in qualified R&D activities in China.

Repave, reuse, recycle. A foreign company with a qualifying infrastructure, environmental, or recycling business in China may be eligible for a three-year tax exemption and a subsequent three-year rate reduction, according to official guidelines. Even companies without such businesses may be able to benefit from tax credits if their Chinese operations set up initiatives that protect the environment, save water, or produce safety equipment.

Sow, reap, go fishing. Companies engaged in agricultural, forestry, animal husbandry, and fishery activities may qualify for lower rates.

Go high-tech. Lower rates also may be available for new high-technology firms in China that own intellectual property and employ knowledge workers.

Companies should also take the following steps to limit their tax exposure and avoid the risk of triggering a Chinese audit:

Mind the ex-pat head count. The presence of a multinational's non-Chinese employees in the country for more than 180 days a year could prompt the authorities to classify the MNC—not just its local subsidiary—as a permanent Chinese establishment and assert that the parent company should be subject to higher taxes. Companies should therefore schedule more-efficient trips, make liberal use of video conferencing, limit employees' in-China vacation time, and monitor non-Chinese employees' time at the summer Olympics in Beijing.

Document, document, document. Certain transfer payments from a Chinese subsidiary to its foreign parent—interest, rent, service fees, some kinds of royalties—will continue to be deductible. But all such payments, along with related employee activities and the transfer of company goods and intellectual property into China, must be properly documented—in Chinese.

The new tax law provides an opportunity for multinationals to fold their global tax strategies into their global business strategies—or, if they have already done so, to reimagine that integration. A well-thought-out integration of strategies will help firms make the most out of China's coming transformation.

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