



THE OECD WELCOMES POLICY ADVANCES AT CHINA'S 2007 NATIONAL PEOPLE'S CONGRESS SESSION

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The OECD welcomes the passing of two laws by China's National People's Congress (NPC) on 16 March 2007 that contribute to an improvement in the investment climate.

The Enterprise Income Tax Law, by setting a single 25% tax rate for domestic and foreign-invested enterprises, ends the uncertainty that has surrounded this policy since China's accession to the WTO at the end of 2001. The Property Law gives equal protection in law to public and private property for the first time since the establishment of the People's Republic of China.

At present, foreign-invested enterprises (FIEs) pay an average of 15% of their income in enterprise income tax, while domestic enterprises pay 25%. The standard concessions for an FIE include top income tax rates of 15% and 24% (depending on factors such as location) which only come into effect in a company's sixth full year of profit-making after a two-year tax holiday and three years at half-rate tax. Further concessions are available in certain sectors and locations. Domestic companies are subject to a standard enterprise tax rate of 33%, mitigated by sectoral and regional incentives. Domestic low-profit enterprises are levied tax at rates of 27% and 18%.

The new law sets a standard rate of enterprise income tax of 25%, regardless of whether the enterprise is Chinese or foreign-owned. The rate is therefore reduced by eight percentage points for domestic enterprises and increased by ten or two percentage points for FIEs. The Chinese authorities calculate that the result will be CNY 41 billion more paid in enterprise income tax by FIEs in 2008, when the law comes into force, while domestic companies will pay CNY 134 billion less, so total revenue from enterprise income tax is expected to be CNY 93 billion lower than if the law had not been enacted.

The new law is in line with the recommendation of the OECD's Investment Committee and Committee on Fiscal Affairs that China attract FDI by enhancing the regulatory framework for investment rather than by offering fiscal and other preferential incentives to foreign investors.

The OECD's *2003 Investment Policy Review of China: Progress and Reform Challenges* cautioned against excessive reliance on special incentives to attract FDI as a substitute for establishing a broad enabling environment for investment characterised by openness, non-discrimination, transparency and effective rule of law.

The 2003 *Review* also stressed that the main concern of FIEs is to ensure that concessions already extended will not be revoked retroactively, but protected by grandfather clauses. The 2007 Enterprise Income Tax Law addresses this concern expressed in the *Review* by not including any retroactive rate change and phasing the increase to 25% for existing FIEs over a five-year transition period, so that they can adapt gradually to the new rate.

As pointed out in the December 2006 Supplement to the OECD 2006 Investment Policy Review of China: Open Policies towards Mergers and Acquisitions, the August 2006 Regulations on the Acquisition of Domestic Enterprises by Foreign Investors make provision for checking on the use of special-purpose entities overseas by Chinese domestic firms making acquisitions in China. The OECD welcomed this as an important addition in view of the generally unrecorded but widespread practice of "round-tripping" by Chinese companies seeking to benefit from incentives offered to foreign investors.

By eliminating incentives for foreign investors, the Chinese government has now removed the motivation for round-tripping, which can be expected to dwindle rapidly. As a result, China's FDI statistics are likely to become more accurate, since they will no longer include an unknown proportion of investment that is really domestic investment disguised as foreign investment. Another beneficial outcome will be increased tax revenue resulting from the closing of this tax evasion loophole.

The removal of fiscal incentives for foreign investors will not remove incentives offered to investors in less-developed regions such as Western China and the Special Economic Zones and into sectors the government wishes to promote, such as environmental protection and renewable energy. As these incentives are non-discriminatory between foreign and domestic investors, they do not detract from the level playing field which the Chinese government is promoting by unifying the general enterprise income tax rate.

The new law also increases the transparency of China's tax regime by bringing all enterprises within the scope of a single law. At present, FIEs are governed by the 1991 Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises while domestic enterprises are governed by the 1993 Provisional Regulations of the People's Republic of China on Enterprise Income Tax. This is a step towards simplification of the plethora of tax legislation affecting FIEs in China. The promised further standardisation of non-discriminatory regional and sectoral tax incentives will also contribute to fulfilment of this objective.

Stronger measures in the new law to deal with tax avoidance, including provisions relating to transfer pricing, are welcomed by the OECD. FIEs currently have a higher tax compliance rate than domestic Chinese enterprises, and multinational corporations are encouraged to comply with the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* and with the *OECD Guidelines for Multinational Enterprises*. China's Finance Minister recently announced that FIEs paid USD 795 billion in all types of taxes in 2006, representing 21.1% of total national tax revenue. This total exceeded by over USD 100 billion the USD 692 billion in cumulative actually-utilised FDI received by China up to the end of 2006. In encouraging increased tax compliance by domestic enterprises, these measures will therefore contribute to a more level playing field.

Statements in the official media about the Property Law, which has yet to be published in full, make it clear that this is also a step forward in promoting a favourable investment climate in China. The law enshrines in law, and reportedly elaborates in detail, the landmark change to China's state constitution in 2004 to include protection of private property. This is a welcome step forward in establishing a firm basis for the protection of investors, both domestic and foreign. However, there may be cases in which investors have acquired land and/or other assets from local governments which the latter are now discovered to have acquired illegally, creating uncertainty for the continuing operation of the enterprises concerned. We are confident that the Chinese government will put in place measures to deal with these and similar issues.

As part of the work programme of co-operation with China, the OECD will share experience on best practices for phasing out distorting incentives for attracting foreign investment and ensuring full transparency of the two new laws at the implementation stage.