

Newsletter (From 1 Apr 08 to 15 Nov 08)

Taxes or expenses not deductible for withholding tax calculation effective from 1 January 2008

Under the new Enterprise Income Tax (“EIT”) law, non-resident enterprise does not have an establishment or place of business in PRC but derives dividends, interest, rental, royalties, capital gains and so on from PRC, or which has an establishment or place of business in PRC but the aforesaid PRC-sourced income is not effectively connected to the establishment or place of business, the withholding tax (“WHT”) is to be applied on the total amount of incomes without any deduction of taxes paid or expenses incurred. On 25 Sep 2008, the Ministry of Finance and the State Administration of Tax (“SAT”) jointly issued a circular (Caishui [2008] No.130) to further reiterate that, when calculating the WHT on PRC-sourced income derived by non-resident enterprises, any tax paid or expense incurred is not deductible effective 1 January 2008.

Hendersen Says

Guoshuifa[1996] No.212 and Caishuizi[1008] No.59 stated that Business Tax (“BT”) paid from the gross rental or royalty income before applying the WHT is deductible. There is no clear guidance on WHT on PRC-sourced income derived by non-residence enterprises after 1 January 2008 while before 25 September 2008. Whether the BT could be deductible remains uncertain.

China issued a circular to clarify EIT implications of service fees charged from a parent company to its subsidiaries in China

On 25 Sep 2008, the SAT issued a circular (Guoshuifa [2008] No. 86) to clarify the EIT implications of service fees charged from a parent company to its subsidiaries in China, including:

- The service fee should be charged based on arm’s length principle, otherwise, the tax authorities have the right to make adjustments;
- Service provided by a parent company to its subsidiaries should be supported with a contract or an agreement which specify the service scope, fee quota and total charges.
- When a parent company providing similar services to its several subsidiaries, the service fee may be charged based on a cost sharing agreement, i.e. the service fee is allocated in the subsidiaries based on the total actual cost incurred plus a certain level of profit.
- The management fee charged by a parent company cannot be deducted for its subsidiaries’ EIT purpose.
- Service fee cannot be deducted for the subsidiaries’ EIT purpose without a service contact or agreement and other supporting documents.

Hendersen Says

Parent companies that provided services to their subsidiaries should review their service arrangements to confirm that they are comply with the requirements set up in the circular. The transactions between a parent company and its subsidiaries should also meet relevant transfer pricing requirements (i.e. documentation requirement) since they are treated as transactions between related parties.

China issued a circular to clarify thin capitalization ratios

On 23 Sep 2008, the Ministry of Finance and the SAT jointly issued a circular (Caishui [2008] No.121) to specify the two debt-to-equity ratio standards and other requirements for deduction of interest expenses incurred on loans from related parties for EIT purposes.

1. Interest expenses incurred on loans from related parties could be deductible for EIT purposes if they meet the two debt-to-equity ratio standards: 5:1 for financial enterprises and 2:1 for others. Excess interest expenses are not deductible for the current and following tax year.
2. Actual interests paid to the resident related parties could be deductible for EIT purpose if the enterprise could provide relevant documents and substantiate relevant transactions are in arm's length principle according to the relevant tax circulars/regulations; or its actual tax liability of the resident borrower is less than that of the resident lender.
3. Enterprises should portion the actual interest expenses for financial business and other business if they are simultaneously engaged in both services. Otherwise, ratio for others should be applicable for the interest expenses incurred from both services.

Hendersen Says

The circular did not mention about how to calculate the debt-to-equity ratio, while the drafted version of Management Rule on Special Taxation Adjustment ("the Rule") issued on 1 Apr 2008 indicates it in Chapter Nine.

Debt-to-equity ratio = Sum of average related-party debt investment from Jan to Dec of the year / Sum of average equity investment from Jan to Dec of the year

Where:

Average related-party debt investment of each month

= related-party debt investment opening and ending balance of the month / 2

Average equity investment of each month

= equity investment opening and ending balance of the month / 2

If the company's debt-to-equity ratio is in excess of the standard and cannot fulfill one of the two conditions, the non-deductible interest expenses may be calculated as following:

Non-deductible interest expenses = Annual interest payable to related parties x (1 - debt-to-equity ratio standard / debt-to-equity ratio of the company)

Interest expenses deemed as dividends may be calculated as following:

Interest expenses deemed as dividends = Annual interest payable to foreign related parties x

(1- debt-to-equity ratio standard / debt-to-equity ratio of the company)

The Rule also specifies documentation requirements if the company's debt-to-equity ratio exceeds the standards:

- Analysis on the borrower's credit and borrowing capacity
- Interest rate, period and capital transactions are in arm's length principle
- Comparability analysis on the conditions and interest determination of related-party and non-related party investment, including the scale and structure of the whole investment, scale and structure of related-party investment, requirements for non-related party to gain similar investment, difference for the interest rate of related-party investment comparing with that of market, and so on.
- Movement of registered capital and investment conditions.

Kindly note the Rule is drafted and is not statutorily final. The calculation formulas and documentation requirements may be changed. Enterprises should wait for the final version to step into the relevant stage.

China issued a circular to uplift of export Value Added Tax ("VAT") refund rates

With the influence of reduction of international market demand, the continuing appreciation of RMB as well as the rising cost of raw materials and labor, the percentage growth in export declined in the first nine months of 2008 compared with the same period in 2007. In order to ease the economic pressure on export companies, the Ministry of Finance and the State Administration of Tax jointly issued a circular (Circular of the Ministry of Finance and the SAT on Raising the Export Tax Rebates of Certain Commodities (2008), Caishui [2008] No.138) on 21 October 2008 to uplift VAT refund rates for labor-incentive products, such as certain textile, apparel, toy, ceramic, plastic, furniture and other products, and highly technology and highly value-added products, such as anti-AIDS medicine. The increase on the export VAT refund rates will come into force on 1 November 2008.

Hendersen Says

The People's Bank of China reduced benchmark lending and deposit rates by 0.27 percentage point on 29 October 2008. This was the third interest rate cut in two months. As the global financial crises and looming recessions in many other economies is continually affecting economic of PRC, the companies should keep an eye on the following actions the government may take to propel domestic investment and sustain China's economic expansion.

China issued three sets of amended provisional regulations of turnover tax

On 14 Nov 2008, the State of Council issued the provisional regulation of VAT which completes the transformation of the production-oriented VAT system to consumption-oriented VAT system

effective on 1 January 2009.

Highlights of the key points are summarized as follows:

1. All general VAT taxpayer can claim input VAT for the new equipment purchased, unused input VAT can be carried forward to offset the future output VAT. Cars, motorcycles and yachts that should be subject to Consumption Tax ("CT") and could be used for private purposes are excluded from the scope. VAT exemption on equipment import and VAT refund on foreign enterprise purchasing domestically-manufactured equipment will be canceled as complied policy to the reform.
2. The VAT rate for general taxpayer remains as 17%, the tax rate for small-scale taxpayer is reduced to 3% and the tax rate on mineral products is shifted back from 13% to 17%.
3. Taxpayer can file VAT on a quarterly basis and the payment deadline is extended.

Meanwhile, the State of Council also issued the provisional regulations of CT and BT to coordinate the transformation of VAT. The amended provisional regulation of CT updated relevant circulars and regulations issued since 1994, i.e. composite taxation method on cigarettes and distilled spirits, adjustments to taxable items and rates, etc. The amended provisional regulation of BT deleted the item regarding the tax basis for re-lending business, which means that the tax basis shall be the interest on lending without deduction of the interest on borrowing. The location for BT payment should be the place where the business establishment is located or domiciled. Both provisional regulations also amended the payment deadline similar to the changes in VAT as mentioned above.

Hendersen Says

The VAT transformation reform will reduce the tax burden of enterprises on fixed asset investment. There is no distinguishing between industry and business for small-scale taxpayers and the tax rate of 3% is adopted for all small-scale taxpayers. Those measures will facilitate the development of industries especially manufacturing industries. The amended provisional regulation of CT updated the relevant circulars and regulations issued after 1994, i.e. it included some taxable items stated in the circular of Caishui [2006] No. 33 and Caishui [2008] No. 105.

Since practical details are yet to be seen in those provisional regulations, we believe that the details are left to be addressed in the amended Implementation Rules to those provisional regulations, i.e. the amended provisional regulation of CT classifies beer into two categories while no specific definition of the two categories is provided; and the amended provisional regulation of BT deleted the detailed description of taxable items from the table of tax scope and tax rates attached to the BT rules.