

Newsletter (From 1 Apr 08 to 15 Nov 08)

- **Update/Supplemental circulars relating to new Enterprise Income Tax (“EIT”) laws**
- Taxes or expenses not deductible for withholding tax calculation effective from 1 January 2008

Circular of the Ministry of Finance and the State Administration of Taxation (“SAT”) on the Issue of Levying EIT on Non-resident Enterprises

Caishui [2008] No.130
Issued on 25 Sep 2008

Summary

Under the new 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 jointly issued a circular (Caishui [2008] No.130) to further reiterate that, when calculating the withholding tax (“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 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.

- EIT implications of service fees charged from a parent company to its subsidiaries in China

Circular of the SAT on the EIT Treatment of Service Charges between Parent Companies and Subsidiaries

Guoshuifa [2008] No. 86
Issued on 25 Sep 2008

Summary

The SAT issued a circular (Guoshuifa [2008] No. 86) clarifying 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 contract 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.

- Clarifying thin capitalization ratios. Specifying the two debt-to-equity ratio standards and other requirements for deduction of interest expenses incurred on loans from related parties for EIT purposes.

Circular of the Ministry of Finance and the SAT on Tax Policy Issues Relating to Pre-tax Deduction Standards for the Payment of Interest by Enterprises to Affiliated Parties

Caishui [2008] No. 121
Issued on 23 Sep 2008

Summary

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.

- Setting forth the key requirements and relevant administrative procedures of recognition of the New and Advanced Technology Enterprises

Notice on Insurance of the Administrative Measures Governing the Recognition of Advanced and New Technology Enterprises

Issued on 14 Apr 2008

Notice on Insurance of the Guidance of Administrative on Recognition of Advanced and New Technology Enterprises

Guokefahuo [2008] No.362

Issued on 8 Jul 2008

Summary

The Ministry of Science and Technology, the Ministry of Finance and the SAT jointly issued circulars (Guokefahuo [2008] No.172 and Guokefahuo [2008] No.362) to set forth the key requirements and relevant administrative procedures of recognition of the Advanced and New Technology Enterprises (“ANTE”).

- Clarify the definition of ANTE;
- Specify the requirement and procedure of the recognition;
- Indicate the time frame and effective period of the recognition;
- List the products or services falling within the scope of the ANTE catalogue;
- Clarify the application of relevant circulars during transaction period;
- Stipulate the commencement of EIT incentives.

Hendersen Says

Enterprises should study the circulars carefully to see if they meet the requirements set out in the circulars. They could also take the drafted guidance as an example to start with the relevant documents preparation. It is not recommended to take any actual actions before the final guidance is released.

● New measures to control inflow and outflow of FOREX funds

Circular of the General Affairs Department of the SAFE on the Relevant Operating Issues concerning the improvement of the Administration of the Conversion of Foreign Currency Capital of FIE and Subsequent RMB Payment

Huifa [2008] No.29

Issued on 2 Jul 2008

Circular of SAFE on the Relevant Issues of the Implementation of the Foreign Debt Registration and Management under the Enterprise Goods Trade

Huifa [2008] No.30

Issued on 2 Jul 2008

Circular of the SAFE on Implementing the Issues concerning Network Inspection Measures for Export FOREX Payment and Settlement

Huifa [2008] No.31

Summary

In order to impede the “hot money”, the SAFE issued several circulars (Huifa [2008] No.29, Huifa [2008] No.30 and Huifa [2008] No.29) to set forth new measures to control inflow and outflow of FOREX funds.

- Enterprises are required to open a special bank account to collect FOREX from export transactions. The deposit service of the account is limited to collect FOREX from export transactions. The withdraw service of the account includes FOREX settlement, transfer FOREX to the frequently project FOREX account, remittance refund, and so on.
- Enterprises are required to perform registration for any advance FOREX export transactions before the actual transactions.
- Enterprises are required to perform similar registration for contract with deferred payment items or deferred payment happened in actual import transactions.

Hendersen Says

Chinese entities with import and export business should comply with the foreign debt registration and de-registration formalities, otherwise, they could be subject to penalty as high as 30% of the export/import payment involved. Kindly note the changes are not only happened on the perspective of procedure, but also on the perspective of quota. According to the circular of Huifa [2008] No.31, the export FOREX collection quota for general trade and import processing trade will be limited to the declared value of export as per the export customs declaration forms. Companies' financing arrangements may be affected as a result of the new mechanism.

Circular of the SAFE on Issues concerning the Improvement of Business Operations with Respect to the Administration of Foreign Exchange Capital Payment and Settlement of Foreign-invested Enterprises

Huizongfa [2008] No.142
Issued on 29 Aug 2008

Summary

SAFE issued Huizongfa [2008] No.142 to administer the conversion of FOREX paid-up registered capital into RMB of foreign invested enterprises (“FIE”).

- Capital verification should be performed on the paid-up capital before its conversion into RMB. The total amount of paid-up capital that can be converted into RMB is limited to the total amount that has been verified by a local CPA.
- The converted RMB should be used within the business scope approved by the relevant government authorities. The converted RMB cannot be used for any domestic equity investment and property investment (except for the purchase of self-use property) unless specifically prescribed in the relevant

regulations. Usage of the converted RMB on security investment should comply with relevant regulations.

- FIEs should follow relevant documentation requirements to apply for converting FOREX into RMB, especially when the amount exceeds USD50,000.

Chinese companies and individuals should collect FOREX through a special bank account when they transfer shares or equity of domestic entities to foreign investors. Similar to FIEs, they are required to provide valid documents to support the usage of the converted RMB.

SAFE will strengthen the supervision on the banks' processing FIEs' application for converting paid-up capital into RMB and tighten the inspection on the usage of such converted RMB.

Hendersen Says

Given the stringent documentation requirement for conversion paid-up capital into RMB, FIEs should make sure that valid documents are available for the application, i.e. a payment order of the converted RMB, for the conversion amount exceeds USD50,000, documents for supporting the usage of the converted RMB and usage breakdown of last conversion substantiated with valid payment invoices should also be provided. FIEs should also be aware the impact of the new circular on their funds usage and financial arrangement.

● **Uplifting of export Value Added Tax ("VAT") refund rates**

Circular of the Ministry of Finance and the SAT on Raising the Export Tax Rebates of Certain Commodities (2008)

Caishui [2008] No.138

Issued on 21 Oct 2008

Summary

With the influence of reduction of international market demand, appreciation of RMB, price rising of raw material 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 (Caishui [2008] No.138) on 21 October 2008 to uplift Value-Added Tax ("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.

- **Third quarter provisional Corporate Income Tax filing for Shanghai Waigaoqiao Free Trade Zone enterprises**

Notice on the third quarter Provisional Corporate Income Tax filing of Waigaoqiao Free Trade Zone enterprises

Issued on 20 Sep 2008

Summary

Waigaoqiao Free Trade Zone issued a notice on 20 Sep 2008 to clarify the preferential treatment during transition period for enterprises in Waigaoqiao Free Trade Zone performing the third quarter provisional EIT filing.

1. Non-manufacturing non-foreign invested enterprises that were set up after 16 Mar 2007 based on business license are allowed to adopt the reduced EIT rate of 18%. The formula to calculate the tax payable for the third quarter is:
Tax payable for the 3rd quarter
= (Total taxable profit for the 1st, 2nd and 3rd quarter – Approved tax losses brought forward) x 18% - Tax paid in the 1st and 2nd quarter
If the tax payable for the 3rd quarter is negative, i.e. the enterprise paid excess EIT, the enterprise should file a nil return for the 3rd quarter. Excess paid EIT could not be refunded, but could be used to offset the tax payable in the 4th quarter.
2. Manufacturing foreign invested enterprises that were set up before 16 Mar 2007 based on business license are allowed to adopt the reduced EIT rate of 18%.
3. Enterprises who are not entitled to the preferential EIT treatment (those that were set up after 16 Mar 2007 based on business license) and that proceeded their EIT filing in 2007 with the rate of 33% should adopt the tax rate of 25% or 23% (for small enterprise with low profitability).
4. Issues on the third quarter EIT filing of holding company with subsidiaries are still pending for further guidance.

Hendersen Says

Enterprises registered in Waigaoqiao Free Trade should follow the instructions stated in the notice to prepare the third quarter provisional EIT filing. Holding companies with subsidiaries should pay attention to further guidance when it is available.

- **EIT treatment on asset disposals**

Notice on Enterprise Income Tax treatment on asset disposals

Guoshuihan [2008] No.828

Issued on 30 Oct 2008

Summary

The SAT issued a notice to clarify EIT treatment on asset disposals (Guoshuihan [2008] No.828) on 30 Oct 2008.

The following assets disposals, excluding assets transferred to overseas could be treated as internal disposals without any deemed sales income issues since assets' ownership remains unchanged:

1. Use of assets to produce, manufacture or process another production;
2. Change of assets' status, structure or function;
3. Change of assets' use, i.e. self-built commercial estates being transferred for self-use or transaction);
4. Use of assets to transferred between a headquarters and its branches;
5. Combination of the above two or more situations;
6. Other use of assets without changing the assets' ownership.

The following use of assets disposals should be treated as deemed sales:

1. Promotion or sales;
2. Entertainment;
3. Staff incentive or welfare;
4. Dividend;
5. Donation;
6. Other situations with changing of assets' ownership.

The deemed price of the self-produced assets should be ascertained based on the sales price of the similar assets in the same period; that of the purchased assets should be ascertained based on the cost price at the time of purchase.

Hendersen Says

Kindly note that the definition of deemed sales is different from the perspective of EIT compared to that of VAT. For example, use of assets to transferred between a headquarters and its branches will not be treated as deemed sales for EIT purposes, while it could be treated as deemed sales under certain circumstance for VAT purpose. Enterprises should consider these differences and understand relevant tax implications.

● Amended provisional regulation of VAT

Provisional Regulation of Value-Added Tax of PRC (amended in 2008)

Order of the State Council No.538

Issued on 14 Nov 2008

People in charge of Ministry of Finance and the SAT explained some issues regarding the provisional regulation of VAT which will be set in forth in 2009.

Issued on the website of SAT on 21 Nov 2008

Summary

The State of Council issued the provisional regulation of VAT on 14 Nov 2008 which will be effective on 1 Jan 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 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-made 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 filing deadline is extended from 10th to 15th. For goods import, the tax payment should be settled within fourteen days instead of seven days after the issuance of the tax payment certificate by the customs office.

Explanation from people in charge of the Ministry of Finance and SAT regarding the provisional regulations of SAT was promulgated on the website of SAT on 21 Nov 2008. The differences between the transformation reform and pilot method adopted for selected industries in specific areas are highlighted as follows:

1. Method for recovery input VAT: VAT tax refund for pilot method while offset output VAT for transformation reform
2. Adopted area: selected industries in specific areas for pilot method while the transformation reform covers the whole country
3. No requirement on VAT tax payable increase when company claims input VAT on equipment purchase for transformation reform

Hendersen Says

Currently, the VAT system disallows the recovery of input VAT incurred on the purchases of fixed assets and requires it to be capitalized as costs of fixed assets. This is called "production-based" system. Since 2004, VAT reform programs have been launched to enable deduction of input VAT incurred on fixed asset purchases for selected industries in specified regions. This is called "consumption-based" system. 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.

● Amended provisional regulation of CT

Provisional Regulations of Consumption Tax ("CT") (amended in 2008)

Order of the State Council No.539

Summary

The State of Council issued the provisional regulation of CT on 14 Nov 2008 which will be effective on 1 Jan 2009. Highlights of the key points are summarized as follows:

1. The amended provisional regulation of CT updated the relevant circulars and regulations issued after 1994, i.e. complex taxation method for cigarettes and alcohol, adjustments on CT items and rates, etc.
2. Taxpayer can file CT on a quarterly basis and the filing deadline is extended from 10th to 15th. For goods import, tax payment should be settled within fifteen days instead of seven days after the issuance of the tax payment certificate by the customs office.

Hendersen Says

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. The amended provisional regulation classifies beer into two categories while no specific definition of the two categories is provided.

● Amended provisional regulation of BT

Provisional Regulations of Business Tax ("BT") (amended in 2008)

Order of the State Council No.540

Issued on 14 Nov 2008

Summary

The State of Council issued the provisional regulation of BT on 14 Nov 2008 which will be effective on 1 Jan 2009. Highlights of the key points are summarized as follows:

1. The amended provisional regulation 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.
2. If the transaction price of service, intangible assets transition and estate sales is obviously low and without proper justification, the tax authorities have the right to access the turnover as the tax basis.
3. The location for BT payment should be the place where the business establishment is located or resident.
4. Taxpayer can file BT on a quarterly basis and the filing deadline is extended from 10th to 15th.
5. No BT taxable items and tax rates table is provided.

Hendersen Says

Since the amended provisional regulation of BT deleted the taxable items and tax rates table, amended implemental rules to the provisional regulation are expected. The regulation also strengthened that deduction cannot be made without valid certificates for those circumstance under which the tax basis is the balance of income

and expense.