



## China Tax Bulletin

Welcome to White & Case's monthly China tax bulletin. This client bulletin includes updates and analysis on recent tax regulations, ensuring you stay up to date on tax developments important to your business.

### Revolutionary VAT law change allowing for the full recovery of VAT on fixed assets

As part of the latest economy stimulus plan aiming to encourage domestic consumption, China has recently made a revolutionary amendment to its VAT law to permit enterprises to fully credit the VAT on fixed assets when calculating VAT payables.

This new rule represents the long-awaited switch of China's VAT system from production based to consumption based. Under a production based VAT system, the 17% VAT paid on the purchase of fixed assets is not creditable. Instead, it is added to the cost of the fixed assets and can be recovered only through depreciation, which can take as long as 10 years. Under a consumption based VAT system, such VAT can be credited against the VAT collected from the sale of products and services immediately. So a taxpayer can recover the VAT on fixed assets much faster.

The new rule had been implemented in certain regions in China on a trial basis over the past few years. However, there were limitations in the previous trial. For example, in those regions, the VAT recovery took the form of a refund, not a credit. So taking the tax back was time consuming. Second, the recovery was limited to certain industries and certain regions. Third, there was a limit on how much tax can be refunded. All those limitations are gone under the amended VAT law. The only limitation is that the VAT on cars, motorcycles and yachts do not qualify for this new rule.

It is expected that manufacturing enterprises will increase their purchases of machinery or technologies because of the tax reform. However, the new incentive applies to only VAT payers, not business tax payers. So companies engaged in financial services, telecom services, transportations, constructions and other services do not qualify and thus cannot benefit from this new rule.

As far as foreign investors are concerned, the immediate benefit will not be much either. This is because many foreign owned companies have been enjoying two incentives, one being VAT exemption on imported equipment and machinery and the other being VAT refund on domestically manufactured equipment and machinery. Those two incentives are now revoked as part of the VAT reform. As such, the new law actually creates a new issue for those companies who would have enjoyed the VAT exemption on imported equipment and machinery because they now have to make an upfront VAT payment. Although the VAT is fully recoverable under the credit mechanism, this creates a cash flow issue for them. For example, a company that plans to import RMB 20 million worth equipment, it will have to spend RMB 20 million plus RMB 3.4 million VAT now (not considering the custom duty effect), instead of RMB 20 million.

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## **New way of calculating withholding tax - Business tax confirmed non-deductible**

Under current domestic tax rules, a non-resident enterprise that doesn't have an establishment in China is liable to pay a withholding income tax at 10% on China source passive income including dividends, interest, rentals, royalties, capital gains, etc. In addition, there is a 5% business tax ("BT") on certain passive income such as rentals and royalties.

According to the tax circulars Guoshuifa [1996] No. 212 and Caishuizi [1998] No. 59, in the case of calculating withholding income tax on rentals and royalties, the BT, which is levied on a gross income basis, is permitted to be deducted before calculating the 10% withholding income tax. For example, if the royalties are 100, the 10% withholding income tax will be levied on 95 (i.e. 100 - BT of 5), instead of 100.

However, the new Enterprise Income Tax Law that became effective on January 1, 2008 states categorically that withholding income tax applies to the total amount of passive income without any deduction. As a result, the deductibility of BT from the total amount of passive incomes in calculating withholding income tax has become unclear since January 1, 2008.

There is an answer to that question now. The newly issued circular Caishui [2008] No. 130, namely *Issues Concerning the Collection of Enterprise Income Tax on Non-resident Enterprises*, officially reiterates that no taxes or expenses can be deducted in calculating withholding income tax on non-resident enterprises effective January 1, 2008. The aforementioned term "taxes and expenses" should include but is not limited to BT.

Circular 130 has clarified the non-deductibility of BT in calculating withholding income tax. However, whether the withholding income tax on passive income calculated after deducting BT and paid before September 25, 2008 (when the circular was issued) needs to be adjusted and whether the tax difference needs to be paid up remains unclear.

## **New debt to equity ratios announced**

The new Enterprise Income Tax Law and the related implementation rules introduced a series of anti-avoidance measures ranging from controlled-foreign corporation rules, general anti-avoidance rules to thin capitalization rules.

Like in other countries, Chinese thin capitalization rules aim to restrict the deductibility of interest expenses on "excessive" related-party debt financing. As a result, the new Enterprise Income Tax Law provides that if the ratio of related party debt to equity

investment is in excess of a prescribed debt-to-equity ratio, the deduction of excess interest is not allowed.

The Ministry of Finance and the State Administration of Taxation jointly issued the circular Caishui [2008] No. 121, *Notice on the Tax Deductibility of Interest Expense Paid to Related Parties*, on September 23, 2008, which sets forth two debt-to-equity ratios and other requirements for deduction of related party interest expenses.

Under Circular 121, for financial enterprises, the debt to equity ratio is 5:1, whereas the ratio is reduced to 2:1 for other enterprises. The interest expenses exceeding the stipulated threshold are non-deductible in the current or subsequent periods.

There are however two exceptions to the above rule. Under Circular 121, related party interest expenses may still be deducted if the enterprise can provide supporting documentation demonstrating that the borrowing is at arm's length, or that the effective tax rate of the borrowing entity is not higher than the rate of the domestic related party that receives the interest.

Circular 121 unfortunately doesn't clarify what kind of documentation should be prepared to testify the arm's length nature of the inter-company borrowing. In the absence of further clarifications, taxpayers should refer to Chinese transfer pricing rules for guidance.

## **New rules on inter-company service fees**

The State Administration of Taxation recently issued the circular Guoshuifa [2008] No. 86 that specifies the enterprise income tax implications of service fees charged by a parent company to its subsidiaries in China. Circular 86 reiterates the arm's length principle, which requires the parent to charge the subsidiaries a service fee based on a reasonable profit. Furthermore, under the circular, a parent company and its subsidiaries should enter into service agreements to set out terms such as service scopes, service fees and total charges as supporting evidence. In the case where a parent company provides same services to several subsidiaries, the service fees may also be charged on a cost sharing basis.

Pursuant to Circular 86, subsidiaries can deduct such service fees for enterprise income tax purposes, as long as they are not management fees, i.e. pure allocations of overheads of the parent company. Management fees are specifically not deductible under the new Enterprise Income Tax Law.

Circular 86 raises an important question that is if the 5% mark-up safe harbor based on the circular Guoshuifa [2002] No. 128 still applies. Under Circular 128, when a foreign owned Chinese holding

company provides regular corporate services to its Chinese subsidiaries or affiliates, it can charge the latter a service fee using a cost plus 5% method. With Circular 86, it appears that the 5% mark-up will not be high enough unless it is considered an arm's length mark-up based on a transfer pricing benchmarking analysis.

### **VAT refund rates on export adjusted to bolster export**

Due to the turbulence in the world economy, China has witnessed a rapid decline in its growth in export. In response, the Chinese government has introduced a number of incentives to deal with this issue. Among those incentives, the most significant tax incentive is the increase in VAT refund rates on export.

On October 21, 2008, the Ministry of Finance and the State Administration of Taxation jointly issued Caishui [2008] No. 138 that raises the export VAT refund rates on 3,486 products, which represent 25.8% of total taxable products listed in China's import and export tariff Code.

Because any non-refundable VAT is a true cost (instead of a time difference), this incentive will result in a true cost saving for many enterprises that are engaged in export sales including Chinese subsidiaries of multinational companies.

### **Long-awaited tax incentive related catalogues issued**

The new Enterprise Income Tax Law provides that qualified enterprises can enjoy various types of preferential tax treatment including reduced enterprise income tax rates, tax holidays, tax credits, etc. The Chinese government has recently issued a series of circulars that detail the scope, criteria and technical standards required to enjoy each preferential tax treatment.

The Chinese government first announced the following five catalogues:

- *The Catalogue of Energy and Water Conservation Equipment Qualified for EIT Preferential Treatment (2008 edition) - Caishui [2008] No. 115 ("EWCE Catalogue");*
- *The Catalogue of Environmental Protection Equipment Qualified for EIT Preferential Treatment (2008 edition) - Caishui [2008] No. 115 ("2008 EPE Catalogue");*
- *The Catalogue of Public Infrastructure Projects Qualified for EIT Preferential Treatment (2008 edition) - Caishui [2008] No. 116 ("2008 PIP Catalogue");*

- *The Catalogue for Recycling Businesses Qualified for EIT Preferential Treatment (2008 edition) - Caishui [2008] No. 117 ("2008 RB Catalogue");* and
- *The Catalogue of Production Safety Equipment Qualified for EIT Preferential Treatment (2008 edition) - Caishui [2008] No. 118 ("2008 PSE Catalogue").*

And then, the government issued the following circulars to further clarify certain issues concerning the implementation of the above catalogues:

- *Notice on Issues Concerning the Implementation of the Catalogue of Public Infrastructure Projects Qualified for EIT Preferential Treatment - Caishui [2008] No. 46;*
- *Notice on Issues Concerning the Implementation of the Catalogue for Recycling Businesses Qualified for EIT Preferential Treatment - Caishui [2008] No. 47;* and
- *Notice on Issues Concerning the Implementation of the Catalogue of Environmental Protection Equipment Qualified for EIT Preferential Treatment, the Catalogue of Energy and Water Conservation Equipment Qualified for EIT Preferential Treatment, and the Catalogue of Production Safety Equipment Qualified for EIT Preferential Treatment - Caishui [2008] No. 48.*

Effective January 1, 2008, enterprises that purchase the above qualified equipment are eligible for a tax credit equal to the 10% of the purchase price in the year of purchase. Excess tax credits can be carried forward for five years. However, a disposal or leasing out of such equipment within five years will result in a recapture of the tax benefit.

For enterprises engaged in the qualified public infrastructure projects that are approved after January 1, 2008, income generated from projects as prescribed in the 2008 PIP Catalogue are eligible for a tax holiday of a three-year exemption followed by a three-year half exemption, starting from the first income generating year.

Also effective January 1, 2008, enterprises that derive income from comprehensive utilization of resources listed in the 2008 RB Catalogue as the main raw materials to manufacture products that satisfy technical standards laid down by the central government are allowed to account for only 90 percent of the revenue as taxable income.

The above circulars however do not provide for the incentive application procedures. This issue will likely be addressed by a follow up circular.

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Our team in China is comprised of preeminent lawyers based in Shanghai, Beijing and Hong Kong, who are recognized for their accomplishments in transfer pricing, as well as for the tax aspects of corporate mergers, acquisitions, reorganizations and joint ventures. Additionally, they provide counsel on inbound and outbound syndicated investment structures involving real property, distressed debt and other assets, financial products and global trading, mutual funds and other domestic and cross-border taxation advisory matters.

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