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## China Tax Bulletin

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

### The SAT has clarified the income tax treatment of certain items related to the transition from the old EIT law to the new EIT law

The State Administration of Taxation ("SAT") has recently issued Circular Guoshuihan [2009] No 98 ("**Circular 98**"), the *Notice of the State Administration of Taxation on Certain Transitional Tax Issues*, to clarify the income tax treatment of certain items specifically related to the transition from the old Enterprise Income Tax Law to the new Enterprise Income Tax Law. It is very useful to all the taxpayers that such a circular is issued when the deadline of the first annual income tax filing after the implementation of the new Enterprise Income Tax Law, *i.e.* May 31, 2009, is approaching.

For your reference, we have summarized the most significant points below. Enterprises should apply those rules to their Year 2008 annual filings.

#### Fixed assets purchased before January 1, 2008

- No tax adjustment shall be made to the depreciations that have already been taken.
- Enterprises have an option to make adjustments to the depreciations of un-depreciated amounts. The residual values and depreciation periods in such cases may be re-established based on the new tax rules.

#### Deferred income

Deferred income that was permitted under the old tax rules can continue to be spread out over the remaining term. One example is the income from debt restructuring can be spread out over a five year period.

#### Staff welfare and education expenses

The staff welfare and education expenses incurred in 2008 should first offset against the remaining balance of such expenses accrued in the prior years. To the extent there is a deficit, the deficit can be deducted in 2008 based on the new tax rules, *i.e.* capped at 14% (staff welfare expenses) and 2.5% (staff education expenses) of the total salaries and wages.

#### Advertisement and promotion expenses

The remaining advertisement and promotion expenses incurred prior 2008 can be carried forward and combined with year 2008's advertisement and promotion expenses. The combined amount can be deducted, subject to the cap under the new tax rules, *i.e.* 15% of the total sales revenue.

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## R&D expenses

Tax losses resulted from the R&D super deductions can be carried forward for five years.

## Start-up expenses

The new Enterprise Income Tax Law is silent on the tax treatment of start-up expenses. Under Circular 78, a start-up enterprise can choose either to take a one time deduction in the year when it starts to operate or to amortize the start-up expenses as long-term expenses, *i.e.* amortized for no less than three years. Once a choice is made, the enterprise cannot change it later. The new rules also apply to the start-up expenses that were incurred prior to 2008 and are still being amortized.

## Limitations on the deductions of handling fees and commissions

In order to further deal with expense deductions under the new Enterprise Income Tax Law, the Ministry of Finance (“MOF”) and the SAT jointly issued Circular Caishui [2009] No 29 (“Circular 29”), *the Notice on the Deductions of Handling Fees and Commissions by Enterprises*. Circular 29 addresses to what extent handling fees and commissions incurred by enterprises can be tax deducted. We have highlighted the salient points below.

First, the deductions are subject to a cap. Specifically, for property insurance enterprises, the cap is 15% of the total net premium. For life insurance enterprises, the cap is 10%. For all other enterprises, the cap is 5% of their total revenue.

In addition, certain handling fees and commissions are not deductible. Examples include handling fees and commissions paid in cash, except in the case where the agent is an individual. Another example is the commissions paid to underwriters in stock issuance cases.

Circular 29 also requires enterprises to prepare and submit proper documentation to support the deductions, such as the basis for calculation and the documentary evidence.

## New comprehensive income tax rules for real estate enterprises

The SAT has recently issued Circular Guoshuifa [2009] No 31 (“Circular 31”), *the Measures to Deal with the Enterprise Income Tax Treatment of Real Estate Development and Operation*, which deal with the specific taxation of real estate development enterprises. This new circular consolidates previous respective

rules on domestic real estate development enterprises and foreign owned real estate development enterprises and contains some changes. The most significant changes are summarized below.

## Reductions in gross margin rates on presales of properties under development

For presales of properties under development, the following gross margin rates shall be adopted for the purpose of calculating taxable income:

- For properties located in the urban and suburban areas of the capital cities of provinces and province equivalent cities, the gross margin rate shall not be less than 15%. The rate was 20% under the old rules.
- For properties located in the urban and suburban areas of cities at prefecture level, the gross margin rate shall not be less than 10%. The rate was 15% under the old rules.
- For properties located in other areas, the gross margin rate shall not be less than 5%. The rate was 10% under the old rules.

## Use of self-developed properties as fixed assets no longer considered a deemed sale

Under the old rules, if real estate developers used self-developed properties as fixed assets, e.g. as rental properties, such transactions would be deemed as sales. Under Circular 31, such transactions are no longer considered deemed sales.

However, the self-developed properties that are used as fixed assets, if they are sold within a 12-month period, no depreciation can be taken.

## Deduction of certain accrued expenses

In general, accrued expenses are not deductible until they are actually paid. Under Circular 31, however, the following accrued expenses can be deducted:

- Accrued construction payments made to subcontractors, but capped at not more than 10% of the total contract amount;
- Accrued construction costs of community facilities that are being built or to be built under an irrevocable commitment; and
- Accrued expenses related to property maintenance in the future that must be paid to the relevant government authorities.

Overall, real estate enterprises in China can now enjoy more favorable income tax treatments under Circular 31.

## More favorable treatment of income from government mandated relocations or asset disposals

The SAT has recently issued Circular Guoshuihan [2009] No 118 (“**Circular 118**”), the Notice of the State Administration of Taxation on Dealing with the Enterprise Income Tax Treatment of the Income Related to Government Mandated Relocations or Asset Disposals, to replace a similar circular issued in 2007, *i.e.* Circular Caishui [2007] No 61. The new circular applies to all kinds of Chinese enterprise, regardless of its ownership, while the 2007 circular applied to domestic enterprises only (as opposed to foreign owned enterprises).

In China, enterprises sometimes are asked by the government to relocate to other locations so that their sites can be used to build infrastructure. Under Circular 118, enterprises that derive income from such government mandated relocations or asset disposals are allowed to exclude such income from their taxable income, as long as the income is used to pay for the acquisition of new fixed assets, the improvement of existing assets, the upgrade of existing technologies, or the employee severance within a 5-year period. Otherwise, they must report the income as taxable income.

The income here includes the subsidies received from the government and the income from the sale of land use rights.

## Hong Kong District Court clarifies its limited jurisdiction

The Hong Kong District Court, in a judgment handed down on February 3, 2009, held that its jurisdiction in tax matters is limited to tax recovery proceedings and does not include a review of whether a tax assessment is excessive or incorrect.

In *Commissioner of Inland Revenue v. Nam Tai Trading Company Limited* (DCTC4250/2008), the Commissioner of Inland Revenue (“**CIR**”) sought to recover HK\$23,682,221, being profits tax for four years of assessment from 1997/1998 through 2000/2001 (the “**Assessments**”) that the defendant had failed to pay, in proceedings before the District Court.

The defendant made the following arguments in its defense:


- (a) The Assessments and/or purported exercise of any power to assess tax were *ultra vires* and of no legal effect, and in particular (i) the assessor did not form an opinion such as to engage the power of assessment under sections 59 and/or 60 of the Inland Revenue Ordinance (the “**IRO**”), or

further/alternatively no assessor properly directed could reasonably have formed such opinion, and (ii) IRO section 61A was not engaged in that it would/could not be concluded that the person or one of the persons who entered into or carried out any transaction bearing on the Assessments did so for the sole/dominant purpose of enabling the defendant either alone or in conjunction with other persons to obtain a tax benefit (the “**Ultra Vires Defense**”).

- (b) Various specific substantive arguments against the assessments (collectively, the “**Assessment Defense**”).
- (c) IRO section 75(4) does not preclude the court from entertaining the plea that the tax sought to be recovered is *ultra vires* or arose from an *ultra vires* assessment (the “**Non-Preclusion Defense**”). (Note: IRO section 75(4) provides that in proceedings under IRO section 75 for the recovery of tax, the court shall not entertain any plea that the tax is excessive, incorrect, subject to objection or under appeal, but nothing in IRO section 75(4) shall be construed so as to derogate from the powers conferred by the proviso to IRO section 51(4B)(a) to give judgment for a less sum in the case of proceedings for the penalty specified therein.)
- (d) Further/alternatively, in purporting to preclude the defendant from raising any plea that the tax is excessive or incorrect, IRO section 75(4) is unconstitutional, void and of no legal effect, having regard to article 35 of the Basic Law, which guarantees to the defendant access to the court and to judicial remedies, and/or to article 10 of the Bill of Rights Ordinance (“**BORO**”), which guarantees to the defendant a fair hearing in the determination of its rights and obligations in the instant suit at law, in which connection IRO section 75(4) serves no legitimate aim and/or is disproportionate (the “**Constitutionality Defense**”).

The District Court took the view that the *Ultra Vires* and Assessment Defenses amounted to assertions that the tax charged under the Assessments was incorrect or excessive.

The District Court held that a plain reading of IRO section 75(4) supported by a long and consistent line of authorities show that in tax recovery proceedings a taxpayer is not entitled to dispute the tax assessment on the basis that it is excessive or incorrect, or what essentially amounts to such contention albeit phrased in a different way. Such complaints should be raised by way of objection/appeal to the Board of Review and the courts. In other words, IRO section 75 confers a very limited jurisdiction on the District Court to deal with the recovery of the tax and not with assessments at all. Therefore,



the defendant was precluded from raising the *Ultra Vires* and Assessment Defenses, which should be raised by way of objection/appeal under Part XI of the IRO.

Under the Constitutionality Defense, the defendant's primary stance was that it should have access to the District Court (being the court with jurisdiction to entertain the CIR's application to collect tax as a civil debt and to give judgment for tax due and payable) to defend the CIR's tax recovery claim. The operation of IRO section 75(4)(a) by restricting any challenge to the CIR's determination of the defendant's objection to a statutory appeal to the Board of Review, which is not a court within the meaning of article 35 of the Basic Law and/or BORO article 10, and (b) by ousting the jurisdiction of the District Court to entertain substantive defenses to the Assessments (e.g., the *Ultra Vires* and Assessment Defenses) or any plea that the Assessments are subject to objection/appeal infringes the constitutional guarantee of access to courts.

The District Court, however, rejected the Constitutionality Defense. It found that taxpayers, including the defendant in the case before it, plainly have a right of access to a *quasi*-judicial body (*i.e.*, the Board of Review) to take any points whatsoever in challenging the correctness of tax charged under the tax assessments backed by appeal to the Court of First Instance or the Court of Appeal under a statutory tax system fully authorized by article 108 of the Basic Law and compliant with article 35 of the Basic Law and/or BORO Art 10. IRO Section 75(4) does not deprive the taxpayers of their constitutional right of access to courts to challenge the tax assessments under IRO.

Consequently, the District Court granted judgment against the defendant for the sum of HK\$23,682,221.00 with interest and costs.

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