



Is There a Cancellation of the Business Tax Exemption for Interest and Rental Income Derived by Foreign Investors?

Guo Shui Fa [1997] 35 ("Circular 35") issued in 1997 has been one of the most favourable tax circulars for foreign enterprises. Under this circular, foreign enterprises are exempted from business tax on interest and rental income from leasing of movable properties derived from China as long as such income is not connected to business establishments in China. However, it appears that such a favourable policy may have been rescinded under Guo Shui Fa [2006] 62 ("Circular 62").

Circular 62 was issued by the State Administration of Taxation ("SAT") on 30 April 2006. Though the ruling is primarily an attempt to provide a comprehensive listing of tax circulars and notices which have been made obsolete or redundant due to newer circulars, it is surprising to find that Circular 35 is on the list of cancellation.

If we were to assume that Circular 62 had the intention of subjecting interest and rental income from leasing of movable properties to business tax, it would be a significant change with far reaching impact to foreign investors. A 5% business tax will be an additional tax cost faced by foreign lenders and foreign lessors on gross interest and rental generally. Companies adversely affected would need to start considering alternative financing or leasing arrangements to mitigate the overall tax costs, including business tax and withholding income tax.

Given there are various unclear points on this matter such as the intent of change, effective date and the implementation details, foreign investors are recommended to keep an eye on this and should consult your professional tax adviser where necessary.

An Update on the VAT Refund Incentive Policy for the Purchase of Domestically Manufactured Equipment

The Ministry of Finance (“MOF”) and SAT have jointly issued Cai Shui [2006] 61 (“Circular 61”) to adjust the VAT refund incentive policy for the purchase of domestically manufactured equipment. Amongst all, one should pay special attention to the salient points below.

Unlike previous circulars, Circular 61 sets out the following types of foreign investment enterprises (“FIEs”) that could qualify for this VAT incentive refund policy:

1. FIEs with general VAT payer status,
2. FIEs engaging in transportation business,
3. FIEs engaging in the development of ordinary residential properties, or
4. Cooperative joint ventures engaging in offshore oil exploitation

In particular, Circular 61 excludes FIEs eligible for VAT credit policy for fixed assets currently applicable in certain industries in the three north eastern provinces.

On the other hand, Circular 61 allows a more lenient administration procedure whereby FIEs may now lodge VAT refund applications for domestically manufactured equipment purchased by their branches (branch factories). Such applications should be lodged in the name of the branch (branch factory) at the branch location.

Circular 61 has reaffirmed the previous requirements. Only equipment purchased for projects within the encouraged category of the Foreign Investment Catalogue or for industries within the meaning of Dominant Industries under the Catalogue for Foreign Investment in the Central and Western China would qualify for this VAT refund incentive. As these two catalogues have been revised since the release of this VAT refund incentive policy in 1999, it raises the applicability issue of various versions of the catalogues. Circular 61 clearly states that reference should be made to the particular version of the catalogue which is or was prevailing at the time of approval for the project concerned.

Similarly, consistent with the previous requirement, any equipment listed in the Catalogue for Import Commodities Not Exempt from Customs Duty for Foreign Investment Projects is not entitled to this VAT refund incentive. As the aforesaid catalogue may be revised in the future, it may also create practical difficulty in determining whether a particular equipment is eligible for the incentive. Circular 61 provides that such determination should be made based on the version of the catalogue prevailing at the time when the particular VAT invoice is issued.

Furthermore, qualifying equipment is defined as equipment manufactured in China and bought as fixed asset, including necessary accessories and spare parts.

Circular 61 has provided added clarity, though the determination of eligible enterprise or eligible equipment could be challenging.

Relaxation of Foreign Exchange Control over Current Account Items

The State Administration of Foreign Exchange ("SAFE") issued Hui Fa [2006] 19, a notice regarding Adjustment of Foreign Exchange Administration under Current Account ("Circular 19") on 14 April 2006 to further relax foreign exchange control over current account items. It has become effective 1 May 2006. We have summarised the salient points as follows:

Entities in China will not be required to get a prior approval when opening, modifying and closing a foreign currency account for current account items ("FCA"). If the entity concerned has opened a FCA previously, it can directly apply with designated foreign currency banks to open a FCA by presenting an application form, its business license and corporate registration certificate. For entities who have not previously opened a FCA, they will need to firstly make a registration with the SAFE.

Circular 19 provides that for an entity with an existing FCA, the maximum amount of foreign currency that can be retained in the FCA should be limited to the sum of 80% of foreign currency income and 50% of foreign currency expenditure of the entity for the proceeding year. For entities with new FCA opened where no prior year benchmark can be referred to, the maximum should not exceed USD500,000.

Documentation requirement for outbound remittance under non-trade items is simplified. For outbound remittance of less than US\$50,000 for an entity or US\$5,000 for an individual, the entity or individual is only required to present the relevant contract or invoice (payment demand note) to the bank to effect payments. For amount exceeding the above limit, tax certificate is still required when the entities effect payments with banks.

In case of outbound payment for on-line services, contract or payment demand note downloaded from the internet with necessary signature or company chop will also be acceptable by banks to effect payments.

For remittance of non-trade items not listed in the current regulations, verification and approval by local in-charge SAFE is required only where it involves transactions over USD100,000. In any event, the central SAFE will no longer be involved in the verification process.

It has also been provided that PRC residents are allowed to purchase foreign currency up to US\$20,000 each year (certain conditions apply).

It appears that the above policy is a move to relieve the pressure resulting from the increasing foreign exchange reserve and to ease RMB appreciation pressure.

In the context of this China Tax / Business News Flash, China refers to the People's Republic of China but excludes Hong Kong Special Administrative Region, Macao Special Administrative Region and Taiwan Region.

The information contained in this publication is for general guidance on matters of interest only and is not meant to be comprehensive. The application and impact of laws can vary widely based on the specific facts involved. Before taking any action, please ensure that you obtain advice specific to your circumstances from your usual PricewaterhouseCoopers client service team.

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