



Thin Capitalization Ratios

Thin capitalization rules are an anti-tax avoidance measure, commonly adopted by many tax jurisdictions to counter the abusive use of loan-finance in order to jet up the interest deduction and hence reduce taxable income of the borrowing enterprise. Prescribed debt/equity ratios form an important part of the thin capitalization rules.

The new China Corporate Income Tax ("CIT") Law has introduced the concept of thin capitalization. The purpose is to disallow the deduction of interest expenses pertaining to debts from related parties when the ratio of debt to equity exceeds a certain prescribed debt/equity ratio. The ratio, however, was not stipulated in the CIT Law or its Detailed Implementation Regulations. Last week, the Ministry of Finance ("MOF") and State Administration of Taxation ("SAT") have jointly published a circular, Caishui [2008] No.121 ("Circular 121") recently setting out the prescribed debt/equity ratio and other relevant rules.

We summarize below the salient points of Circular 121:

1. There are two prescribed debt/equity ratios -- one for enterprises in the financial industry and the other one for non-financial enterprises. The former is set at 5:1, while the latter at 2:1. Where the ratio of the debts from related parties to the equity exceeds the certain prescribed debt/equity ratio in a year, the interest expense pertaining to the debts from related parties shall not be deductible in that year (and no carry-forward to future years), except in situations where the criteria set out in Point 2 below is met. The prescribed ratio for enterprises in the financial industry is higher than that for non-financial enterprises as financial arrangements in finance industry have their particular features.
2. The excessive interest expenses may still be deductible if an enterprise can provide documentation to support that the inter-company financing arrangements comply with the arm's length principle; or if the effective tax rate of the borrowing enterprise is not higher than that of the domestic lending enterprise.
3. If an enterprise carries on both financial business and non-financial business, it has to segregate the related party interest expenses between the two businesses on a reasonable basis; otherwise, it has to follow the prescribed debt/equity ratio for non-finance industry. i.e., the 2:1 ratio, in calculating its deduction threshold for related party interest expense.
4. The lending enterprise shall be subject to CIT on the full amount of interest income (including the non-deductible portion of the borrowing enterprise) in accordance with the relevant tax regulations.

PwC Observation

Borrowing enterprises in China which source their loan finance from related parties have been eagerly waiting for the announcement of these prescribed debt/equity ratios. This may be a disappointment to them as the ratios are lower (and more stringent) than international standards.

Although the prescribed debt/equity ratios have now been set, there are still some uncertainties about the thin capitalization rules, including:

- Circular 121 does not explicitly spell out the date of the new thin-capitalization ratios and rules to be effective.
- Circular 121 does not define what the exact scope of financial industry is, which can enjoy a higher debt/equity ratio of 5:1, than others.
- Circular 121 does not elaborate on issues, such as, how to calculate the debt/equity ratios, the type of documentation required to substantiate the arm's length nature of the inter-company borrowing, etc.

We understand that these issues will be addressed in the “Administrative Measures on Special Tax Adjustments” (“Administrative Measures”) to be released by the SAT later. However, the comprehensive draft Administrative Measures circulated by the SAT in mid March this year seeking feedback from local-level tax bureaus, professional accounting firms and other selected parties may provide some hints to these questions:

- The debt/equity ratio shall be calculated on a monthly weighted average basis in order to avoid potential manipulation by taxpayers throughout the year.
- The effective date should be 1 January 2008 as the thin capitalization ratios will be assessed on a yearly basis.
- There may also be Interest Levy on the tax underpayment resulting from the interest expense disallowance made by the tax authorities under the thin capitalization rules. However, the 5% penalty tax may be waived if the enterprise has prepared contemporaneous documentation to substantiate that the arm’s length nature of the inter-company borrowings.
- Such documentation may include analysis of the repayment ability and the borrowing capacity of the borrower, explanation of the arm’s length nature of the interest rate, loan period, etc., comparable analysis of the terms and conditions of the related party loans with unrelated party loans, etc.

Circular 121 confirms that the thin capitalization rule in China is punitive, i.e. the borrowing enterprise may suffer from the disallowed portion of the related party interest expense, while the lending enterprise would be subject to China tax in respect of the interest in full extent. So the tax consequence could be undesirable if there is adjustment for excessive related-party interest deduction under the thin capitalization rules. The borrowing enterprise should review their inter-company borrowing level against the equity level, and assess whether the prescribed debt/equity ratio has been exceeded. Where commercially viable, it is advisable to make necessary adjustments to its financing sources and mix. Since it is coming close to the year end, it could be a top priority to make good the debt-equity ratio back to the allowable level. If exceeded, it should consider how to invoke the arm’s length exception (Point 2 above) by justifying the arm’s length nature of the inter-company borrowings. In any event, documentation to justify the arm’s length principle for the intercompany borrowings appears to be a good strategy to distant from the 5% penalty tax in case of any adjustment.

As mentioned above, there are still some unclear issues in Circular 121. Companies should stay tone to the upcoming Administrative Measures relating to the thin capitalization rules. We will closely monitor the development and share it with our clients timely.

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

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