CHINA

WITHHOLDING INCOME TAX ON DIVIDENDS TO FOREIGN SHAREHOLDERS

Before 1 January 2008, dividends distributed by Chinese companies to their foreign shareholders were exempted from withholding income tax (WHT) in the following situations under the old Foreign Enterprises Income Tax (FEIT) Law:

1. WHT was exempted on dividends distributed by foreign invested enterprises (FIEs) to their foreign shareholders. For the purpose of this exemption, more than 25% of shares of the FIE has to be held by foreign shareholders.
2. WHT was exempted on dividends distributed by Chinese companies listed in overseas stock exchanges (e.g. shares listed in the Hong Kong Stock Exchange, also known as H Shares; shares listed in the New York Stock Exchange, also known as N Shares; etc.) to their foreign investors.

With the replacement of the old FEIT Law by the new Corporate Income Tax (CIT) Law which took effect from 1 January 2008, the above WHT exemption on dividends was annulled accordingly. The China's State Administration of Taxation (SAT) released two circulars, Caishui[2008]No.1 (Circular 1) and Guoshuihan[2008]No.897 (Circular 897), to provide transitional relief and to reinforce the imposition of WHT on dividends.

WHT on dividends derived by foreign investors from FIEs

Pursuant to Circular 1, dividends distributed by FIEs out of profits earned prior to 1 January 2008 to foreign investors in 2008 or after will still be exempt from WHT; only dividends distributed by FIEs out of profits earned after 1 January 2008 to foreign investors will be subject to WHT.

WHT on dividends derived by foreign corporate investors from H Shares

Circular 897 sets out that:

1. Chinese listed companies issuing H Shares have to withhold WHT at the rate of 10% on the distribution of dividends for 2008 and beyond to foreign corporate investors of H Shares; and
2. If the foreign corporate investor is eligible for tax treaty rate (usually lower than 10%), it is allowed to apply for refund of the overpaid WHT upon application and approval of the Chinese tax authorities.

Although Circular 897 only addresses the WHT treatment on H Shares, our discussion with the SAT seems to suggest that the principles in Circular 897 should also apply to other overseas listed shares.

It is still uncertain whether the phrase of "dividends for 2008 and beyond" per Circular 897 refers to the dividends distributed in 2008 and beyond or to the dividends distributed out of profits earned in 2008 and beyond. Using the spirit of Circular 1, there is an argument to support that it refers to the latter and that the WHT exemption treatment granted under the old FEIT Law shall still apply to dividends paid out of pre-2008 profits.

SPECIAL TAX ADJUSTMENTS IMPLEMENTATION MEASURES

China's CIT Law, together with its Detailed Implementation Regulations (DIR), introduced a set of anti-avoidance measures in Chapter 6 — Special Tax Adjustments. It may well be the most complex chapter of the CIT Law, encompassing not only exploratory new concepts such as cost sharing, controlled foreign corporations, thin capitalisation, general anti-avoidance, but also imposing mandatory contemporaneous transfer pricing documentation requirements, that could altogether cause significant impact to taxpayers.

In January 2009, the SAT released the "Implementation Measures of Special Tax Adjustments (Trial)" (the Measures) which lay out detailed rules on administering the anti-avoidance measures in Chapter 6. The Measures contain 13 Chapters and 118 provisions which take retrospective effect from 1 January 2008.

Impact on taxpayers

The most worth noting points of the Measures are summarised below:

Definition of related parties

The Measures include a very broad (inclusive) definition of related parties, not only including the criterion on share ownership (i.e. more than 25%) but also with a special focus on the feature of "effective control" that can arise in situations of indirect share ownership, major financers, common management, significant suppliers and customers, etc.

Chinese enterprises should carefully review their relationships with business partners (i.e. major suppliers, customers and financers) as well as relationships with their directors and high-level management with reference to the definition of related parties included in the Measures, in order to plan their transfer pricing documentation and disclosure compliance accordingly.

Annual disclosures of related party transactions

Taxpayers are required to file Related-party Transaction Disclosure Forms (RPT Disclosure Forms) together with their annual CIT return filing package. There are as many as 9 different forms that may need to be filed.

These RPT Disclosure Forms require companies to indicate whether they have contemporaneous transfer pricing documentation (TPD) in place to substantiate their inter-company arrangements and to provide very detailed information on each type of related party transactions (including specifying the applicable transfer pricing methods). In the first year, the RPT Disclosure Forms need to be filed by 31 May 2009, subject to further local-level requirements, together with the 2008 annual CIT return.

Much of the analytical work ultimately to be included in the TPD will form the basis for completing the RPT Disclosure Forms and determining whether any voluntary adjustments should be made on the annual CIT return. Such work will have to be at least substantially completed by the annual CIT return filing, despite the extended due date for 2008 TPD. In addition, assembling TPD involves significant amount of data collection as well as functional and economic analyses, and even Chinese translation work that could be very time consuming. It is therefore strongly recommended that taxpayers begin the process of assembling their TPD as soon as possible. Early planning and preparation make things easier and more complete.

Transfer pricing documentation

Enterprises doing business in China must have relevant TPD in place in order to avoid an additional "interest levy" of 5% (the so-called "penalty component") on the transfer pricing adjustments occurred.

There are 26 specific items of TPD under five broad categories:

1. Organisational structure
2. Description of business operations
3. Description of related party transactions
4. Comparability analysis
5. Selection and application of transfer pricing method

Failure to submit TPD upon request may result in the Chinese tax authorities deeming the enterprise's taxable income and assessing a 5% "penalty component" (in addition to a "financial component" that is based on the normal People's Bank of China's lending rate) as part of the "interest levy".

Enterprises are exempt from the TPD requirements if they meet any of the following criteria:

1. The annual amount of related party purchase and sale transactions of tangible goods is below RMB200 million and the annual amount for all other types of transactions (i.e. services, royalties, interest, etc.) is below RMB40 million;
2. The related party transactions are covered under an advance pricing arrangement; or
3. The foreign shareholding of the enterprise is below 50% and the enterprise only has related party transactions locally.

It is important to note that, according to the Measures, the TPD must be:

1. prepared and maintained for each tax year;
2. completed by 31 May of the following year (i.e. 31 May 2010 for 2009 tax year) and kept for 10 years (i.e. until 31 May 2020 for 2009 tax year). The due date for the 2008 tax year will be extended to 31 December 2009 as a concession for the first year;
3. provided within 20 days of request by the in-charge Chinese tax bureau (or within 20 days after elimination of any force majeure);
4. stamped with "official chop" and signed or sealed by the legal representative of the enterprise; and
5. in Chinese (any source materials provided in foreign language as part of the TPD needs to be translated into Chinese).

Transfer pricing methods

The Measures list six methods as the “appropriate methods” in the course of transfer pricing investigations. They are the same methods provided in the OECD’s transfer pricing guidelines. The Measures provide further guidance on the application of each of the first five transfer pricing methods. The Measures also indicate that the selection of the most appropriate transfer pricing method should take into account the following five comparability factors:

1. Characteristics of the assets or services involved in the transaction
2. Functions and risks of each party engaged in the transaction
3. Contractual terms
4. Economic circumstances
5. Business strategies

The Measures do not indicate any preference or hierarchy for selecting transfer pricing methods. Practically, this would on one hand allow more flexibility, but it would also put the onus of proof to taxpayers to justify the reasonableness of the transfer pricing method they adopt.

Transfer pricing investigations and adjustments

The Measures provide guidance on the procedural aspects of transfer pricing investigations which are generally in line with China’s previous transfer pricing rules and practical enforcement. According to the Measures, transfer pricing investigations shall focus on enterprises with the following characteristics:

1. Significant amounts or numerous types of related party transactions
2. Long-term losses, low profitability, or fluctuating pattern of profits/losses
3. Profitability lower than those in the same industry, or with profitability that does not match their functions/risks
4. Business dealings with related parties set up in a tax haven
5. Absence or incomplete TPD and/or Disclosure Forms
6. Obvious violation of the arm’s length standard

Although the Measures introduce the inter-quartile range as a method of testing profitability, they provide, in the context of transfer pricing investigations, that enterprises with profits below the median value will still be subject to an adjustment to the amount at least equals to the median value. How the SAT will use this authority remains to be seen, but it will likely cause difficulties in devising transfer pricing policies and/or determining the amount of a voluntary adjustment.

Advance pricing arrangement (APA)

The Measures provide guidance with respect to the various requirements and procedures associated with applying for, negotiating, implementing, and renewing an APA. In general, these provisions are a restatement of the previous rules on APA, with several modifications and amendments. The following points are most worth noticing:

1. The SAT has specified that APAs will in general be applicable to enterprises meeting the following conditions:
   (1) annual related party transactions of no less than RMB40 million;
   (2) comply with the related party disclosure requirements; and
   (3) prepare, maintain, and provide TPD
2. The term for an APA will cover transactions for three to five consecutive years (the previous provisions provided that APA would cover two to four years)
3. Upon approval of the Chinese tax authorities, the pricing policy and calculation method adopted in the APA can be applied to the evaluation and adjustment of related party transactions in the year of application or any prior years, if the related party transactions in prior years are the same as or similar to those covered in the APA

The above measures indicate that the SAT is getting increasingly more open to assist taxpayers with APA to reduce the uncertainty associated with transfer pricing issues.

Cost sharing agreement (CSA)

It was a breakthrough that CSA for joint development of intangibles and sharing of services were finally written into the CIT Law. The SAT will require certain items to be contained in a CSA which generally follows OECD’s transfer pricing guidelines. The Measures provides that service-related CSA generally should be limited to group procurement or group marketing strategies.

Thin capitalisation

The thin capitalisation rules are designed to disallow the deduction of excessive related party interest expense pertaining to the portion of related party debt-to-equity ratio exceeding a certain prescribed debt-to-equity ratio. According to an earlier circular, Cai Shui [2008] No. 121 (Circular 121), the prescribed safe harbour debt-to-equity ratios are 2:1 for non-financial enterprises and 5:1 for enterprises in financial industry. Circular 121 also emphasises that "excessive interest" from related party financing that exceeds the applicable prescribed ratio 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 burden of the Chinese borrowing enterprise is not higher than that of the Chinese lending enterprise.

Where the debt-to-equity ratio exceeds the prescribed ratio, the portion of related party interest expense relating to the excessive portion would not be deductible. Furthermore, the non-deductible outbound interest expense paid to overseas related parties would be deemed as a dividend distribution and subject to withholding tax at the higher of the withholding tax rate on interest and the withholding tax rate on dividends.

Preparation of thin-capitalisation TPD is required in order to deduct excessive interest expense. The Measures stipulate that such documentation should prove that all material aspects of the related party financing arrangements, including debt-to-equity ratio, interest payment amounts, interest rates, duration of debt, terms and conditions, etc. are with an arm's length.

General anti-avoidance rules (GAAR)

The Measures state that the Chinese tax authorities may commence a general anti-avoidance investigation on an enterprise in case of any of the following scenarios:

1. Abuse of preferential tax treatments
2. Abuse of tax treaties
3. Abuse of corporate structure
4. Use of tax havens for tax avoidance purposes
5. Other "arrangements" that do not have a reasonable business purpose

The Measures place a special focus on the principle of substance over form. The Measures also provide details about the various procedures for conducting a "GAAR investigation" and making a "GAAR adjustment", including the requirement that initiation of all GAAR investigations and adjustments must be submitted to the SAT for approval. The consequence could be that the Chinese tax authorities may disregard the "tax benefits" obtained from the tax avoidance arrangements. Where an enterprise is lacking adequate business substance, especially if it is in a tax haven country, the Chinese tax authorities may disregard the existence of such enterprise.

Corresponding adjustments

The Measures provide that corresponding adjustments should be allowed in the case of a transfer pricing adjustment to avoid double taxation in China.

Legal liabilities

As discussed above, in cases of failure to submit TPD upon request, or submission of false or incomplete information, the Chinese tax authorities have the power to deem the enterprise's taxable income and assess a 5% "penalty component" (in addition to a "financial-charge component") as part of the "interest levy" on any special tax adjustments made by the tax authorities. This interest levy is not deductible for CIT purposes.

REFORM IN THE TURNOVER TAX REGIMES

China's State Council amended the Provisional Regulations of Value Added Tax (VAT), Business Tax (BT) and Consumption Tax and their respective detailed implementation rules at the end of 2008. The amended regulations have become effective from 1 January 2009.

The following major changes in the amended VAT and BT regimes will affect foreign enterprises with investment or doing business in China. There is no significant change in the consumption tax regime.

Major changes to the VAT regime

The most important change to the VAT regime is the transformation of the VAT system from "production-based" to "consumption-based" effective from 1 January 2009. Consequently, input VAT incurred on fixed assets is eligible for credit against output VAT starting from 1 January 2009.

To compliment the above transformation in the VAT system, the following VAT incentives were removed effective from 1 January 2009:

1. The VAT refund policy on purchase of domestically-made equipment by FIEs. However, there is a 6-month grandfathering period for FIEs affected by such policy change.
2. The VAT exemption treatment for the importation of equipment by taxpayers engaged in projects encouraged by the State. A 6-month grandfathering period is also available to some of the projects under certain conditions.

The cancellation of the above VAT incentives will not affect most of the general-VAT taxpayers since the input VAT on the fixed assets is now creditable against the output VAT. However, for those taxpayers who cannot claim input VAT credit (e.g. small-scale VAT taxpayers and non-VAT taxpayers, etc.), the cancellation will increase their operating costs.

Major changes to the BT regime

BT is levied on taxable services provided in China. The major change to the BT regulations is the definition of "provision of services within China". Under the previous BT regulations, it refers to the location where the services are rendered, whereas the amended BT regulations refer it to the place where the service recipient or service provider is located. In other words, commencing from 1 January 2009, as long as the service recipient or service provider is located in China, BT will be imposed on the service income regardless of where the service is rendered. We anticipate that this would cause significant impact to many foreign service providers rendering services inside and outside China to Chinese service recipients or non-Chinese service recipients. It is advisable for these service providers to review their BT exposure arising from their services related to China as soon as possible to determine the appropriate course of actions.