

Insights and Commentary from Dentons

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China Tax Update

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CLIENT ALERT

This update includes the following topics: 1) State Administration of Taxation ("SAT") Reinforces Tax Collection Under the Recession; 2) Employee Secondment From Overseas Entities is Subject to Tax Inspection; 3) SAT Scrutinises Transferring Losses into China; 4) Deferred Capital Contribution Will Eliminate Some Deductible Interest; 5) Additional Deduction of Advertising and Promotional Expenses is Allowed in Certain Industries; 6) China Offers Tax Incentives to the Animation Industry.

STATE ADMINISTRATION OF TAXATION ("SAT") REINFORCES TAX COLLECTION UNDER THE RECESSION

Struggling in this recession to achieve its 2009 tax revenue target, SAT in April 2009 has issued a circular that requires local tax authorities to strengthen various aspects of tax collection.¹ In July 2009 SAT issued a second circular containing 20 detailed measures to guide tax collection work.² Below, we summarize the material impact that these circulars may have on our clients:

Enterprise Income Tax ("EIT")

Local tax authorities must enhance the administration of the quarterly EIT pre-payments from taxpayers and prevent the late payment of tax. Specifically, at least 70% of the annual total EIT liabilities of a taxpayer must be pre-paid by quarterly EIT filings. Taxpayers who are administered by local tax authorities as key local tax resources must pre-pay (in principle) EIT in line with their actual profits.

Branches and their respective headquarters are supervised more strictly. Tax authorities at different locations will cooperate on information exchange, verification and inspection on branches and their headquarters.

A taxpayer in any of the following situations now is more likely to be subject to tax inspection:

- It incurs losses for more than three consecutive years,
- It has long-term marginal profits or losses;
- It has sharp changes in profits and losses;

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¹ Several Opinions on Strengthening Tax Collection and Closing Tax Loopholes (Guo Shui Fa [2009] No. 85)

² Several Detailed Measures on Further Strengthening Tax Collection (Guo Shui Fa [2009] No. 114)

- It incurs loss after its tax holiday expires;
- It has an abnormal change in taxable income.

Individual Income Tax ("IIT")

Local tax authorities will cooperate with other government authorities (e.g. Entry-Exit department of the Public Security Bureau, Foreign Exchange Administration Bureau) to enhance the taxation of expatriates. The tax authorities will set up files for expatriates and may request information exchange with the tax authorities of their home countries. Tax inspection will focus on the expatriates' income sourced from China but paid by overseas entities.

Value-added Tax ("VAT")

In the past, a general VAT payer who imported goods could credit import VAT paid before verifying the relevant VAT payment voucher issued by customs ("Customs VAT Voucher"). Under this practice, there have been some cases where faked Customs VAT Vouchers were used to get the VAT credited and evade VAT payment.

SAT now requires that the credit of import VAT be allowed only after the Customs VAT Voucher is verified following specified procedures. So under the new practice, the general VAT payer pays more VAT in advance because the credit of VAT is deferred.

International Taxation

Local tax authorities are required to make in-depth inspections to prevent tax avoidance. They are due to start transfer pricing inspection on industries that are less influenced by the global financial crisis, such as financing for infrastructure construction, tyre production, pharmaceutical and hotel chain industries. Tax authorities will support bilateral advance pricing arrangements and other transfer pricing negotiations requested by multinational companies.

Tax authorities will check the taxation of non-resident enterprises that dispatch employees to China to provide management, design, verification or consulting services. Tax inspection will focus on issues relating to payment of non-residents in construction contracting, dividends distribution, loan interest and share transfer, etc.

Salans Comments: A tax inspection "storm" has swept through China. Local tax authorities usually require taxpayers to self-review and pay any outstanding tax within a certain period of time. Based on the result of self review, the tax authorities will decide whether to conduct spot-checks. Under Chinese law, tax evasion is subject to penalties ranging from 50% to 5 times the unpaid tax. We know of cases where the tax authorities have imposed penalties as high as 5 times the amount of the unpaid tax detected on spot checks. Also note that under the newly revised Criminal Law, persons responsible for a tax payer may have criminal liabilities if the tax evasion amount is relatively big and constitutes over 10% of the tax payable.

We advise our clients to make a thorough tax "health check" on their Chinese subsidiaries as soon as practical. After that, remedial measures can be planned and adopted to reduce potential risks.

EMPLOYEE SECONDMENT FROM OVERSEAS ENTITIES IS SUBJECT TO TAX INSPECTION

In July, SAT issued a letter³ (“Letter”) to local tax authorities, requiring them to inspect non-resident enterprises which have income from China through the “Secondment Service Model” where:

- An overseas entity signs a secondment agreement or others with an inland entity to second its employees to the latter as the latter’s senior management personnel, technician, etc.; while the inland entity pays secondment fee or other fee to the overseas entity.

According to a Chinese regulation,⁴ overseas entities which contract project or provide service in China must make tax registration as well as declare and pay taxes in China from 1 March 2009. The Letter requires local tax authorities to check the outbound payment records of a mainland entity to verify whether relevant overseas entities have made tax registration and declared taxes; if an overseas entity has not fulfilled its EIT liabilities in China, it must pay the overdue taxes within the prescribed period along with interest surcharges and penalties.

The Letter suggests that the inspection on manufacturing and service industries will be scrutinised; automotive manufacturing is a key sector as “automobile manufacturers should be checked one by one”.

Salans Comments: The Secondment Service Model has been frequently used by foreign invested enterprises (“FIEs”) with their overseas affiliates. In the past, this model was not strictly supervised and many overseas entities were not required to pay tax for receiving secondment fees if they were regarded as salaries of the seconded employee. From 2009, SAT issued several circulars to increase supervision of the non-resident enterprises and the Letter can be regarded as a measure to enforce these circulars.

The Letter suggests that if the tax authorities conclude after examining the secondment agreement or other evidence that an overseas entity has created a “permanent establishment” in China as defined in the relevant tax treaties and Chinese tax law, then the overseas entity must pay business tax (“BT”) and EIT on top of the secondment fee.

We advise our clients to review their secondment arrangements, and if necessary, to restructure secondment agreements and payment routes in order to reduce tax risks.

³ Letter concerning the Investigation of Enterprise Income Tax Collection on Services Provided to Domestic Enterprises by Foreign Entities through Seconding Personnel (Ji Bian Han [2009] No. 103)

⁴ Provisional Measures on Tax Administration of Non-Residents Engaging in Contracting Projects and Services (SAT’s No. 19 Decree of 2009)

SAT SCRUTINISES TRANSFERRING LOSSES INTO CHINA

In July 2009, SAT issued further measures to enforce transfer pricing regulations and protect the tax basis.⁵ Where a multinational company has a Chinese subsidiary whose function and risk is limited, such as where its sole function is production, distribution or contracting research and development the subsidiary must now retain reasonable profits. During the global financial crisis these subsidiaries should not assume market or decision-making risks from other group companies.

SAT further requires that when a subsidiary incurs a loss, it should prepare and submit contemporaneous transfer pricing documentation for the current year ("TP Documentation") to the relevant tax authority by 20 June of the following year, regardless of whether it meets the regulatory threshold requiring TP Documentation.

SAT stresses that local tax authorities should strengthen the supervision of cross-border related party transactions, especially for those where losses (or potential losses) are shifted from overseas related parties to Chinese entities and where profits made by Chinese entities are shifted to tax havens.

Salans Comments: Chinese companies subject to this circular face an increased level of scrutiny and an increased possibility of transfer pricing audit. These companies should prepare their TP Documentation carefully to justify losses and then submit it on time.

DEFERRED CAPITAL CONTRIBUTION WILL ELIMINATE SOME DEDUCTIBLE INTEREST

SAT has issued a circular⁶ to clarify the issue of interest deduction for a company whose investor fails to make capital contribution on time. Where a company has obtained loans and must pay interest, that part of the interest that corresponds to the deferred paid-in capital amount cannot be deducted from the company's taxable income. SAT considers that this part of the interest should not be a reasonable expense of a company.

Salans Comments: Chinese law requires investors in a newly established FIE to complete the contribution of registered capital by installments according to the schedule set out in the FIE's articles. The maximum permissible time, in which the registered capital can be paid up, is 2 years after the issue of the FIE's business license. Nevertheless, administrative penalties on deferred capital contributions were not strictly enforced in many cases. This circular will impose additional costs on investors if they defer their capital contribution. We would like our clients to note that in principle this circular also applies to capital increase cases.

⁵ Circular on Strengthening Supervision of Cross-border Related Transactions (Guo Shui Han [2009] No. 363)

⁶ Reply on Issues concerning the Deduction of Interest Incurred Due to Deferred Capital Contribution by Investors (Guo Shui Han [2009] No 312)

ADDITIONAL DEDUCTION OF ADVERTISING AND PROMOTIONAL EXPENSES IS ALLOWED IN CERTAIN INDUSTRIES

China's EIT regulations allow a taxpayer to deduct its advertising and promotional expenses ("A&P Expenses") by a maximum amount of 15% of its sales (operating) revenue unless otherwise stipulated by the State's finance or tax authorities. SAT issued a circular⁷ in July 2009 to stipulate the following deduction policies effective during the period from 1 January 2008 to 31 December 2010:

- Cosmetics, pharmaceutical or beverage (excluding alcohol) manufacturers may deduct qualified A&P Expenses up to 30% of the sales (operating) revenue;
- The franchisee beverage manufacturer can deduct its A&P Expenses directly within the above cap or pass such expenses to the franchisor, who may then deduct them as sales expenses; and
- No tobacco manufacturer may deduct any A&P Expenses for tobacco.

Salans Comments: Since this circular took effect retrospectively from the 1 January 2008, affected enterprises must adjust their tax payable for 2008 according to the policies contained therein. According to the *Circular regarding EIT Declaration for 2008* (Guo Shui Han [2009] No.286), enterprises must correct their former declaration for 2008 at the competent tax bureau before 31 December 2009 and will not be subject to penalties or legal liabilities if the correction is handled appropriately.

CHINA OFFERS TAX INCENTIVES TO THE ANIMATION INDUSTRY

In 2006 China introduced policies to set up a platform to support the development of its animation industry. To implement these policies, in July 2008 SAT and the Ministry of Finance released a circular to provide the following tax incentives to animation enterprises:⁸

- Before 31 December 2010, an animation enterprise that is a "general taxpayer of VAT" who develops and produces its own animation software is entitled to a refund of part of its actual VAT burden (exceeding 3% VAT) after it has paid 17% VAT.
- An animation enterprise which develops and produces its own animation productions may enjoy a tax holiday (i.e. two years EIT full exemption and three years EIT half exemption) and other EIT incentives granted to software enterprises, for instance, shorter depreciation or amortization periods on software assets etc.

⁷ Circular on Policies of Deducting Advertising and Promotional Expenses in Certain Industries (Cai Shui [2009] No.72)

⁸ Circular on Relevant Tax Policies on Supporting the Development of Animation Industry (Cai Shui [2009] No. 65)

- Before 31 December 2010, an animation enterprise may enjoy a reduced business tax rate of 3% on its animation-related services, such as animation script writing, image design, background design, animation design, sub-mirror, animation making, film, tracing lines, coloring, picture synthesis, dubbing, scoring, sound effective synthesis, editing, subtitling, compression codec (for web animation, mobile animation format adapter) services.
- Import VAT and customs duty on the goods related to development and production of animation products are exempt.

To qualify for these incentives, animation enterprises must be recognized by the relevant provincial level authority.⁹

Salans Comments: The animation industry is a sunrise industry in China. Animation enterprises include cartoon creation companies, animation creation and production companies, web animation creation and production companies, animation software development companies and animation derivative products design and development companies, etc. These companies must achieve certain thresholds to be recognized as of animation enterprises. These thresholds include the ratio of the animation product revenue to total revenue, ratio of the R&D expenses to the total revenue, etc

⁹ Rules on the Recognition of Animation Enterprises (Trail) (Wen Shi Fa [2008] No.51)

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