

China Tax Highlights

May 2011

This Newsletter will introduce you with RSM China's readings of the recent significant updates:

1. Several Issues Concerning the Administration of Income Tax on Non-Resident Enterprises
2. Issuance of New Regulations on CIT Pre-tax Deduction



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I. Several Issues Concerning the Administration of Income Tax on Non-Resident Enterprises

Announcement 24 of the SAT, 2011

Announcement 24 claims several issues on the CIT obligations and procedures of non-resident enterprises under new CIT laws, it makes tax policies in new CIT law for non-resident enterprises more understandable and exercisable.

II. Issuance of New Regulations on CIT Pre-tax Deduction

Announcement 25 of the SAT, 2011

Announcement 25 provides a series of overall and detailed stipulations on pre-tax deduction of asset losses. Compared with previous stipulations, Announcement 25 has 5 significant changes.

I. Several Issues Concerning the Administration of Income Tax on Non-Resident Enterprises

On March 28, 2011, the State Administration of Taxation (“SAT”) issued *Announcement 24—Announcement of the SAT on Several Issues Concerning the Administration of Income Tax on Non-Resident Enterprises*. *Announcement 24* takes effect from April 1, 2011.

The new corporate income tax (“CIT”) laws and related implementing regulations effective from January 1, 2008 have made previous regulations based on old CIT laws abolished, which result in lacking of regulations on some common problems occur in practice. *Announcement 24* clarifies several issues on the CIT obligations and procedures of non-resident enterprises under new CIT laws, besides, it makes tax policies in new CIT law for non-resident enterprises more understandable and exercisable. Its main contents are as follows:

1. Complements and Clarifies Resident Enterprises’ Withholding Issues

The new CIT laws stipulates, when enterprises within the territory of China (including foreign-invested enterprises and domestic enterprises) pay non-resident enterprises outside of China interests, rents and royalties (“Three Payments”), withholding obligations of CIT shall be fulfilled. However, under the circumstance that the aforementioned sums which are due and payable but have not yet been paid, whether enterprises in China shall still withhold CIT?

Article 1 of *Announcement 24* answers this question:

- Where the enterprises in China include the Three Payments one-off into costs and expenses, regardless of whether it have been paid or not, the counter party’s CIT shall be fully withheld in current year;
- Where the enterprises in China include the 3 payments into costs and expenses by installments, regardless of whether have been paid or not, the counter party’s CIT shall be fully withheld in the first installment.

2. Clarifies Issues Concerning the CIT Rate of Guaranteed-cost Income Sourced Abroad

Article 2 of *Announcement 24* clarifies where the non-resident enterprise obtains guaranteed-costs income from enterprises within China, CIT shall be calculated and withheld base on the rate of interest income as regulated in the CIT law.

3. Updates the Method of Calculating CIT for Non-resident Enterprises' Transfer of Land Use Rights

Article 3 of *Announcement 24* stipulates the calculation method of non-resident enterprises' transfer of land use rights, namely,

(Total Transfer Income – Tax Base) X CIT Rate

Comparing with CIT laws and regulations' stipulations "for asset transfer income, taxable income is determined by subtracting net value of the asset from total transfer income", *Announcement 24* has adjusted "subtracting net value of the asset" to "subtracting tax base", which reduces CIT on non-resident enterprises' transfer of land use right. Related non-resident enterprises shall calculate the tax base of land use right to evaluate *Announcement 24* influences.

4. Clarifies Issues Concerning Tax Treatment of Rental Income Derived from Financial Leasing and Leasing Real Estates

Article 4 of *Announcement 24* stipulates, for the rents received by non-resident enterprises for providing financial leasing to enterprises in China, CIT shall be calculated consulting to the CIT rate on loan interests and withheld upon payment by enterprises in China.

(Rents+Transfer Income after Expiration-Purchase Price) X CIT Rates on Loan Interest

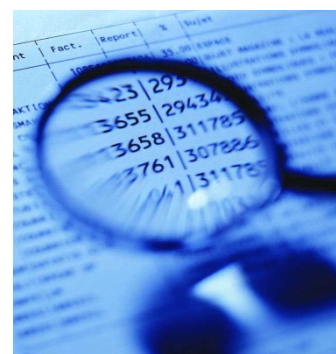
Besides, Article 4 also stipulates, if the non-resident enterprise carries out daily management of aforesaid real estate by delegating working staff or entrusting other institutions or individuals in China, it should be considered as setting up permanent establishment. Which means CIT is imposed by tax authorities on appraised rate. The designated personnel is subject to individual income tax in China, besides, the permanent establishment shall perform the statutory obligation of paying other related taxes (ie. business tax).

5. Clarifies Times for Recognizing Income and Other Conceptual Issues on Non-resident Enterprises' Transfer of Chinese Enterprises' Share Equities

The tax issue of non-resident enterprises' transfer of share equities of Enterprises within China is under the discretion of Guoshuihan [2009] No. 698 (*"No.698"*). *Announcement 4* clarifies the times for recognizing income and other concepts in *No. 698*.

- For deals proceed by installment, income is recognized upon the effectiveness of contract and the finalization of equities transfer procedures;
- "Purchase and sell stocks in open market" shall be conducted according to fair market value, or else CIT shall be levied within China based on the balance of transfer income subtracts the cost price;
- In the "indirect transfer" article of Article 5, the term of "actual tax burden" refers to the actual tax burden of income derived from the transfer of share equities; the term of "exemption from income tax" means the income from transfer of share equities is exempted from the CIT. In the "right of veto" article of Article 6, the term of "oversea investor (actual controller)" refers to all investors who indirectly transfer share equities of Chinese resident enterprises;
- For non-resident enterprises' indirect transfer of share equities of enterprises within China, the procedures of providing materials are further clarified. Where two or more oversea investors indirectly transfer share equities of an enterprise within China at the same time, any party is allowed to file materials to competent tax authorities; where an overseas investor indirectly transfers share equities of two or more Chinese enterprises at the same time, materials can be provided to any Chinese enterprises' competent tax authorities; if tax is decided to be imposed, the overseas investor shall respectively pay taxes to each competent tax authorities at places where Chinese resident enterprises are located.

[Note: No. 698 stipulates, for non-resident enterprises' transfer of the share equities of enterprises within China (excluding purchase and sell stock in open market), income is recognized as the balance of transfer price subtracts equity cost]



II. Issuance of New Regulations on CIT Pre-tax Deduction

On March 31, 2011, the SAT issued *Announcement 25* of 2011, ie, *Measures for the Administration of Pre-tax Deduction of Enterprises Asset Losses for CIT Purpose*. *Announcement 25* provides a series of overall and detailed stipulations on pre-tax deduction of asset losses. Compared with previous stipulations, *Announcement 25* has following changes:

1. Asset Losses is deductible upon filing

The previous stipulations provide, qualified asset losses are subject to self-administered deduction; other asset losses are subject to deduction upon prior approval. *Announcement 25* changes above regulations as such losses are deductible upon filing. This is the most note-worthy issue in *Announcement 25*.

Filing shall be conducted simultaneously with CIT annual filing. For previous self-administered deduction losses, a consolidated list of losses is needed for filing, and proving materials are of no necessary; for asset losses previously within the scope of administrative approval, such losses shall be filed on an item-by-item basis together with related materials.

Announcement 25 ushers tax authorities' innovation on tax collection and administration methods. After the changes from losses approval to losses filing, administrative approval is further faded, and replaced by tax administration. For enterprises, when filing asset losses, they should prepare the entire proving materials and have materials preserved in a proper way, or else they will be required to repay the tax, together with surcharges and a penalty above 50% and below 5 times of the tax.

2. Broadens the Scope of Asset Losses

Announcement 25 broadens the scope of asset losses to intangible asset losses, advance payment losses, loan losses, bundling sales losses, losses caused by internal reasons or innovations incoordinate with policies, and criminal matter losses.

It is remarkable that, losses incurred from loans between enterprises and individuals are not within the deductible scope of asset losses.

3. Double-filing of Branches

Announcement 25 clarifies the issue concerning the filing of asset losses in headquarter and branches' consolidated payment of CIT. The branches shall file their asset losses to competent tax authorities and headquarter; headquarter shall gather and list branches' asset losses, and then file to competent tax authorities.

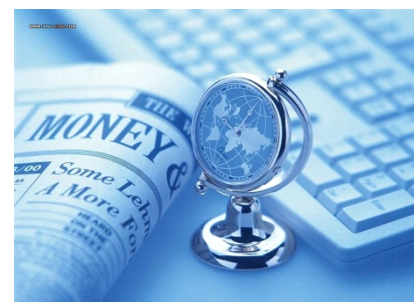
4. Special Filing Required for Recovering Previous Years' Unsettled Asset Losses

For asset losses incurred in previous years but failed to be filed, *Announcement 25* stipulates each loss shall be prepared with special material to file for deduction, and generally the recovery period shall not exceed 5 years.

For losses incurred after recovery, *Announcement 25* stipulates only incurring year's losses are adjustable, then to offset following years' CIT, no tax refund is applicable.

5. Qualified Losses Incurred during the Process of Transferring Assets to Related Parties is Deductible

Announcement 25 provides, when enterprises transfer assets, provide loans or guarantees to administrative enterprises, if arm's length principle is observed, losses incurred are deductible upon filing. However, special materials must be prepared for filing, and report issued by professional tax agents is needed.



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