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CHINA INSIDER INTERNATIONAL

见风转舵
Change one's position when having difficulties

穴来风未必无因
There is no smoke without fire

有志者. 事竟成
Where there is a will, there is a way

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Editorial

The news of this International China Insider reveals the fact that China passes more and more tax regulations to clarify various questions especially regarding direct taxes of foreign investments and Wholly Foreign Owned Enterprises. In doing so China´s enterprise income tax system becomes more and more convergent to the direct tax systems of other industrialized countries.

The same development is noticeable regarding the transfer pricing regulations. The demands for documentation and application of arm´s length conditions come also steadily closer to international standards. It is very important for companies investing in China to consider these developments and new regulations.

FOREIGN INVESTMENTS IN CHINA

Foreign Partnership Regulations Enter Into Force

The Measures on Establishment of Partnership Enterprises by Foreign Enterprises or Individuals (FIP Measures), which were issued by the State Council on 25 November 2009, came into effect on 1 March 2010.

The FIP Measures, which consist of 16 Articles, provide guidelines on the establishment of 'foreign investment partnerships' (FIPs) in response to the Partnership Law of the People's Republic of China amended on 27 August 2006 and effective as of 1 June 2007. Now those rules applicable to FIPs include the Partnership Law and the FIP Measures, among others.

According to the FIP Measures, an FIP established by foreign enterprises or individuals in China may be one of two types – an FIP that is established by two or more foreign enterprises or individuals or one that is jointly established by foreign and Chinese entities or individuals.

The FIP regime offers two types of partnership entity – a general partnership and a limited partnership. The basic requirements for establishing an FIP include a partnership agreement, contribution of capital, the FIP's name and place of business etc. There is no minimum threshold for the capital contribution; and the capital can be contributed in cash (Chinese statutory currency or freely exchangeable foreign currencies), tangible property, intellectual property, land use rights, and other property, as well as labour.

Unlike the situation with traditional foreign investment vehicles (such as wholly foreign-owned enterprises and Chinese-foreign equity or contractual joint ventures), no approval from the Ministry of Commerce (MOC) or its affiliates is required to set up an FIP. However, an FIP must register with the competent administration for industry and commerce (AIC) in order to obtain a business licence. In principle, the AIC will issue a business licence or reject an application for within 20 days of the receipt of the application documents. If the AIC approves the business-licence registration, it will notify the MOF or its affiliates at the same level of the relevant registration information.

As with traditional foreign investment vehicles, FIPs are subject to foreign investment industry policies (for example, the Foreign Investment Industry Guidance Catalogue, revised by the National Development and Reform Commission and the Ministry of Commerce on 31 October 2007). Under these policies, some industries (for example, telecommunications and development of large tracts of land) fall under the 'restricted' or 'prohibited' category for foreign investments.

By allowing the establishment of FIPs, China has created an important investment vehicle available for foreign investors to enter into the Chinese private-equity and venture-capital market. However, the implementation of the FIP-Measures results in some uncertainties for FIPs in some areas (such as financing, accounting, taxation, foreign exchange, and customs), which should be clarified by the government and its departments in the future. For example, currently there may be some issues for FIPs regarding banking and profit distributions. Thus, further guidelines (especially those for institutional investors) should be issued to enhance the development of the Chinese private-equity and venture-capital market.

♦ by Giai-Mau Ma, China Desk, BDO Germany

State Council Issues New Rules to Attract Foreign Investment

On 6 April 2010, the State Council promulgated Guofa [2010] No 9 – Several Opinions on Further Improving the Utilisation of Foreign Investment (hereon – 'the Opinions') – which provides general guidance designed to encourage foreign investors to invest in China.

The Opinions state that the Foreign Investment Industry Guidance Catalogue ('the Catalogue') will be revised to encourage foreign investment in high-end manufacturing industry, high-new technology industry, modern service industries, and new energy and energy-saving industries. China will continue to improve its high-tech enterprise recognition system to enable foreign investment enterprises to benefit from the status and also provide support on qualified Chinese-foreign joint technology-development projects.

The Opinions also state that multinational companies are encouraged to set up regional headquarters, research and development centres, procurement centres, finance and administration centres, and cost and profit accounting centres in China.

The Opinions also declare their support for participation by foreign investors in restructuring and mergers and reorganisations of domestic enterprises through purchasing equity and becoming strategic investors in companies listed on Chinese stock exchanges.

Furthermore, foreign investors are encouraged to set up venture-capital enterprises; and the capital-quit mechanism for venture-capital enterprises will be improved. Qualifying foreign investment enterprises will be encouraged to initiate the public offering of shares and issue corporate bonds and medium-term notes in the Chinese stock market. The scope of foreign entities eligible to issue yuan renminbi-denominated bonds in China will be gradually broadened.

In terms of the approval régime, the Opinions provide local authorities with more foreign-investment approval rights to reflect the government's commitment to simplifying approval procedures. The Opinions specify that encouraged and permitted foreign investment projects as stipulated under the Catalogue with a total investment amount of less than USD 300 million may be reviewed and approved by local authorities, except those that are subject to approval by relevant departments of the State Council in accordance with the Catalogue of Investment Projects Approved by Government. Hence, local authorities have the right to approve a project with foreign investment of up to USD 300 million (formerly USD 100 million), except those projects that are expressly subject to approval from the central government under the catalogue of restricted foreign investment projects. Specifically, a foreign investment project with a total investment amount of more than USD 50 million in a 'restricted industry' is still subject to review and approval by the relevant departments of the State Council.

The foreign-exchange administration on foreign investment enterprises will be improved and the foreign-exchange settlement procedures for foreign investment enterprises capital will be simplified for the purpose of establishing a friendly foreign-investment environment, according to the Opinions.

Observations

The Opinions set out a framework for China's foreign investment policies in the future but do not contain implementation guidelines in many areas. For example, it is still unclear what amendments will be made to the Catalogue, what preferential policies will be provided for foreign investment in the Chinese central and western regions, what rules will be issued to govern national security review of foreign investors' M&A, and when the 'international board' of the Chinese stock market will be formally launched.

♦ by Jessica Wu, BDO China

New Tax Rules for Representative Offices of Foreign Companies

On 20 February 2010, the State Administration of Taxation (SAT) issued Guoshuifa [2010] No 18 – Provisional Measures for the Administration of Taxation on Representative Offices of Foreign Enterprises (hereon – Circular 18) – which provides guidance on the income tax treatment of foreign enterprises' representative offices (ROs) in China.

Circular 18, which has retroactive effect from 1 January 2010, stipulates that an RO should file and pay enterprise income tax (EIT) based on the profits attributable to itself and should file and pay business tax and value added tax on taxable revenue in accordance with the relevant tax regulations. An RO that is eligible for an exemption from EIT pursuant to a relevant tax treaty or tax arrangement may file supporting documents with the competent tax authorities in support of its claim to the EIT exemption. For example, an RO may not constitute a permanent establishment and therefore may be exempt from the EIT, if it is set up for the purpose of carrying on activities of a preparatory or auxiliary character according to a relevant tax treaty or tax arrangement.

Circular 18 provides for both actual and deemed-profit methods for the purpose of computing the EIT of ROs. A deemed-profit method applies where an RO cannot provide a complete accounting record or if it cannot accurately calculate its income and expenses as follows:

- if an RO can accurately compute operating expenses but cannot accurately compute its turnover or costs, its EIT is calculated using the formula: EIT = operating expenses of the current period / (1 - deemed profit rate – business tax rate) × deemed profit rate × EIT rate; and
- if an RO can accurately compute gross income but cannot accurately compute costs and expenses, its EIT is calculated using the formula: EIT = gross income × deemed profit rate × EIT rate.

For EIT purposes, operating expenses of an RO generally include all expenses incurred by the RO inside and outside China, excluding monetary charitable donations that are applied in China, late-payment fees, penalties, and expenses that are unrelated to the business operations of the RO but that are paid by the RO on behalf of its head office. Fixed assets and decorating costs arising at start-up or relocation of the RO will be treated as a one-off expense and thus will not be depreciated or amortised for the purposes of the EIT computation. Interest income cannot be offset against the operating expenses.

Circular 18 increases an RO's deemed profit rate from 10% to 15% or greater. As a result, an RO's EIT and BT liability will increase if it is taxed using the deemed-profit method.

An RO that qualifies for a tax exemption under an applicable double treaty should submit sufficient supporting documents to the tax authorities in a timely manner regardless of whether it has obtained tax-exemption approval from the tax authorities; failure to do so may cause withdrawal of the exemption, according to Circular 18 and related domestic tax rules.

♦ by Stone Yang, BDO China

SAT Sets Deemed-Profit Rates for Foreign Companies

On 20 February 2010, the State Administration of Taxation (SAT) also issued Guoshuifa [2010] No 19 (hereon – Circular 19), which provides guidance on how to compute a non-resident enterprise's enterprise income tax (EIT) in China.

Applicable Scope

Circular 19 is applicable to non-resident enterprises with an establishment in China and which derive Chinese-source income through the establishment and overseas income effectively connected with the establishment. Representative offices are taxed according to Guoshuifa [2010] No 18, also issued by the SAT on 20 February (see above).

Deemed-Profit Methods

Circular 19 provides for actual and deemed-profit methods for a non-resident enterprise's EIT calculation. A deemed-profit method is applicable to non-resident enterprises that cannot accurately calculate their taxable income or file income tax returns on an actual-profit basis because of presenting incomplete accounting records or for any other reason. In that case, the tax authorities are entitled to assess the enterprise's taxable income using one of the following deemed-profit methods:

- a gross-income-based method applies where a non-resident enterprise can accurately calculate or deduce its gross income using reasonable methods but cannot accurately calculate its costs and expenses. The formula is as follows: Taxable income = gross income x deemed-profit rate;
- a cost-plus method applies where a non-resident enterprise can accurately calculate its costs and expenses but cannot accurately calculate its gross income. The formula is as follows: Taxable income = total costs and expenses / (1 – deemed profit rate) x deemed profit rate; and
- an expenditure-based method applies if a non-resident enterprise can accurately calculate its total expenditure but cannot accurately calculate its gross income and costs and expenses. The formula is as follows: Taxable income = total expenses / (1 – deemed profit rate – business tax rate) x deemed profit rate.

Deemed-Profit Rates

Circular 19 sets out the following range used to determine a nonresident enterprise's deemed profit rate:

- 15% to 30% for construction projects and design and consulting services;
- 30% to 50% for management services; and
- 15% or more for other services or any business activities other than services.

Circular 19 also states that the relevant tax authorities can apply a higher deemed-profit rate if they believe that a non-resident enterprise's actual profit rate obviously exceeds the deemed-profit rate established in Circular 19 based on evidential support.

Onshore and Offshore Contracts

According to Circular 19, a non-resident enterprise will calculate and pay EIT on Chinese-source income if all the services are provided within China. If the services are provided both within and outside China, onshore and offshore service income will be allocated according to the sourcing principle, under which only Chinese-source income is taxed in China. If the tax authorities question the reasonableness and authenticity of the income allocation within and outside China, they are entitled to ask the non-resident enterprise to submit authentic, valid documents supporting the allocation. Failure to submit the documents can entitle the tax authorities to treat all of the services as taking place in China for tax purposes.

A contract that covers the sale of equipment or goods and also the provision of services (such as installation, assembly, technical training, and supervision) should clearly include separate fees for the services. If such service fees are not stated in the contract or their calculation is unreasonable, the tax authorities will reserve the right to determine the service fees by applying the standard fee for the same or similar services. If there are no such standards for reference, the service income will generally be deemed to be at least 10% of the contract value.

♦ by Stone Yang, BDO China

INCOME TAX

China Issues Foreign Tax Credit Instructions

On 2 July 2010, the Chinese State Administration of Taxation (SAT) released Bulletin [2010] No 1 (Bulletin 1) providing detailed foreign tax credit (FTC) instructions for its FTC system. Bulletin 1 is the first normalized taxation document since the Administrative Rules for Formulation of Normalized Taxation Documents came into effect on 1 July this year. It provides details on each clause of Caishui [2009] No 125, issued by the Ministry of Finance and the SAT on 25 December 2009.

Bulletin 1 confirms that the FTC system applies to both resident enterprises (including enterprises that are incorporated under foreign laws but recognized as Chinese tax residents because of their effective management place in China) and nonresident enterprises with an establishment in China.

Foreign taxes qualifying for FTCs must have an enterprise income tax (EIT) character (which is determined mainly based on whether they are paid on a net income basis) and be computed and paid in accordance with foreign tax laws and related provisions. Also, the taxes must be payable and actually paid for purposes of qualifying for FTCs, unless tax sparing credits or other exceptions apply.

Qualified foreign taxes for nonresident enterprises' establishments in China are those that have an EIT character and directly paid by the establishments for their overseas income effectively connected with the establishments. For example, interest income received by a foreign bank's branch in China from an overseas borrower from a loan made by the branch using its governable funds is overseas income that is effectively connected with the branch, Bulletin 1 says. It also confirms that the FTCs available for nonresident enterprises are limited to direct FTCs only.

Overpaid foreign income taxes resulting from the application of an income tax rate greater than a rate offered by an applicable double taxation arrangement (DTA) will not be eligible for an FTC, according to Bulletin 1. Bulletin 1 says that enterprises should not apply any overpaid foreign income taxes to FTCs but request tax refunds from the competent foreign tax authorities.

Bulletin 1 also provides that foreign income tax rebates received from various tax concessions offered by foreign governments pursing given goals must be deducted from the total amount of foreign income taxes for FTC purposes. Also, taxpayers will not qualify for FTCs on foreign income taxes paid for foreign-source income that is taxable in a foreign jurisdiction but exempt from the EIT under China's tax laws and regulations.

Tax sparing credits apply to resident enterprises' foreign income taxes that are exempted or reduced by a DTA partner's domestic tax laws and also deemed to have been paid under an applicable DTA after they are confirmed by the taxpayers' competent tax authorities, according to Bulletin 1. The tax sparing credits will not be applicable if the simplified methods as stated in Caishui [2009] No 125 are used to compute the FTCs. Bulletin 1 also clarifies that an enterprise's foreign-source income that is nontaxable under the tax laws of a source jurisdiction but taxable under the tax laws of China is outside the scope of tax sparing credits and is therefore fully taxed in China.

Bulletin 1 has retroactive effect from 1 January this year. It also applies to FTC matters for tax years 2008 and 2009 as long as they have not been settled.

♦ by Glen Wei, China Desk, BDO USA, LLP

China Clarifies Income Tax Benefits for Agricultural Companies

On 9 July 2010, China's State Administration of Taxation issued Bulletin [2010] No. 2 (Bulletin 2), which clarifies the enterprise income tax (EIT) treatment of taxpayers that use the "company plus farmer" business model in agriculture, forestry, animal husbandry, and fishery projects. Bulletin 2 says that these enterprises are entitled to the EIT exemption and reduction incentives provided by China's relevant EIT laws. Bulletin 2 has retroactive effect from 1January 2010.

In the company plus farmer model, a company provides immature livestock and poultry, feedstuff, veterinary medicine, vaccine, and other materials to a farmer who then delivers mature livestock and poultry to the company after the harvest on a contract basis, according to Bulletin 2.

Bulletin 2 explains that why such enterprises qualify for the tax benefits is that they establish consignment contracts with formers and own the legal titles of such raw materials and finished goods in the whole process of the production. Also, the companies assume market, management, purchases, sales, and other business functions as well as almost all business management risks.

China's EIT laws provide an EIT exemption for enterprises on income arising from the cultivation of stipulated vegetables, plants, new agricultural products, Chinese medicinal herbs, and trees; the raising of livestock and poultry; the collection of forestry products; and the provision of ocean fishing activities and of services relating to agriculture, forestry, animal husbandry, and fishery projects.

The tax system also provides enterprises a 50% EIT reduction on income generating from the cultivation of flowers, tea, and other beverage and spice crops, and from sea and inland waters aquaculture.

♦ by Glen Wei, China Desk, BDO USA, LLP

China Begins Nationwide Examinations of Transfer Pricing Documentation

Only 12 July 2009, China's State Administration of Taxation (SAT) decided to inspect taxpayers' transfer pricing documentation for tax years 2008 and 2009 by issuing a circular Guoshuihan [2010] No 323.

The SAT instructed local tax authorities to work out a list of enterprises subject to the contemporaneous documentation requirements for tax years 2008 and 2009, respectively, using the information of annual related-party transactions filed by the enterprises. Then, they will examine the transfer pricing reports of at least 10% of all the enterprises for 2008 and 2009, respectively.

The focus of the examinations will be taxpayers' organizational structure, business operations, related-party transactions, comparability analysis, and the selection of transfer pricing methods. The tax authorities will evaluate each selected transfer pricing report and record their examinations on a stipulated form. They are instructed to submit the result of the examinations to the SAT by October 31 this year.

Under China's transfer pricing rules, taxpayers must submit transfer pricing contemporaneous documentation to the tax authorities within 20 days once they are instructed to do so.

♦ by Glen Wei, China Desk, BDO USA, LLP

SAT Clarifies Treatment of Capital Gains and Dividends

Guoshuihan [2010] No 79 (hereon – Circular 79), which clarifies the income tax treatment of capital gains, dividends, rental income, income from debt restructuring, start-up costs, depreciation of fixed assets, deduction of tax-exempt expenses, and the entertainment deduction for investment enterprises under the Enterprise Income Tax (EIT) Law and its implementation regulations, was issued by China's State Administration of Taxation (SAT) on 22 February 2010.

Capital Gains

Gains derived from the transfer of equity interests are recognised after the equity-transfer agreement is executed and the procedures for the change in equity ownership are completed. Retained earnings (such as undistributed profits) attributable to the transferred equity interests cannot be deducted when calculating the gains.

For example, assuming that a foreign investor receives a consideration of USD 10 million from a transfer of the shares in its wholly foreign-owned enterprise in China that has registered capital of USD 1 million (investment cost of the shareholder) and retained earnings of USD 7 million at the time of the transfer, the capital gains derived by the foreign investor from the equity transaction are USD 9 million (and not USD 2 million because the retained earnings cannot be deducted from the sales price. If the buyer sells them to a third party for USD 11 million immediately after its purchase of the shares, then its capital gains will be USD 1 million because its purchase cost for the shares is USD 10 million.

Dividends

Dividend income must be recognised on the day that shareholders decide to make a distribution of dividends or to convert retained earnings into equity. The conversion of share premiums into equity by an enterprise will not be considered as a distribution of dividends and therefore will not increase the tax basis of shareholders' investment costs.

Rental Income

If the rental period of a lease agreement extends beyond a calendar year and the rent is paid in advance, the lessor may allocate the rental income evenly over the lease term other than recognise one-off revenue, according to the matching principle of revenue and expenses under the EIT Law and its implementation regulations. However, the lessor becomes liable to pay 5% business tax on the whole amount immediately on receipt: the spreading method is not available under the applicable business tax regulations.

Income From Debt Restructuring

Income from debt-restructuring transactions is recognised on the day the debt-restructuring contract or agreement becomes effective.

Start-Up Costs

An enterprise will start to calculate its profits or losses for tax purposes in the year it commences its manufacturing or business operations. Expenses incurred during the start-up period will not be recognised as losses until the commencement of the manufacturing or business operations but then will be deducted in full in the year of commencement of the operations or evenly amortised over a stipulated period of tax years.

Depreciation of Fixed Assets

If an enterprise has not received all invoices for fixed assets that have already been put into use because it has not made all the required payments, the enterprise can temporarily use the value stated in the agreement as the tax basis for depreciation purposes. However, an adjustment must be made to reflect the actual invoice amount within 12 months of the date on which the assets were put to use.

Deduction of Tax-Exempt Expenses

Unless otherwise stipulated by the relevant tax laws, costs and expenses incurred in connection with tax-exempt income are deductible when computing taxable income. Such tax-exempt income includes, for example, interest income from government bonds and dividends distributed between Chinese-resident enterprises, according to the implementation regulations to the EIT Law.

Entertainment Deduction for Investment Enterprises

Under the EIT Law, entertainment expenses available for a tax deduction are limited to the smaller of 60% of the total amount of the entertainment expenses and 0.5% of the taxpayer's annual sales revenue. That rule may cause a problem on the deduction of entertainment expenses for investment enterprises whose income mainly consists of dividends and capital

gains other than sales revenue. Circular 79 clarifies that enterprises engaged in investment activities (for example group headquarters and venture-capital enterprises) may deduct their entertainment expenses based on stipulated ratios for tax purposes.

♦ by Stone Yang, BDO China

SAT Clarifies Preferential Treatment of Foreign Investment Enterprises

The old Foreign Investment Enterprise and Foreign Enterprise Income Tax Law (FIET Law) and its implementation regulations (repealed on 1 January 2008) provided qualifying foreign investment enterprises (FIEs) with certain tax holidays such as a tax holiday consisting of a two-year income tax exemption followed by a three-year 50% income tax reduction and a tax holiday consisting of a five-year income tax exemption followed by a five-year 50% income tax reduction.

To qualify for the holidays, enterprises were generally required to conduct their business activities for a minimum period. If their actual operating period was shorter than that minimum period, they were obliged to repay the exempted or relieved tax, unless otherwise provided. However, the old law did not expressly state whether FIEs would be obliged to repay the tax if they were deregistered because of changes to the government's national development planning (such as urban construction planning).

On 12 February 2010, China's State Administration of Taxation issued Guoshuihan [2010] No 69 (hereon – Circular 69), which confirms that an FIE that has already enjoyed an EIT exemption or reduction but begins winding-up procedures must pay the exempted or reduced tax if its actual operating period was less than the designated operating period required for that preferential tax treatment.

Circular 69 also states that a foreign investor of an FIE must repay any tax rebate (40% of EIT paid) received from pre-2008 reinvestment in the FIE as an increase of registered capital or in a new FIE as capital using profits earned from that FIE if it withdraws the reinvestment within five years.

An FIE or foreign enterprise must, at lease or sale, pay the amount of EIT already covered by a tax credit earned from the purchase of domestic equipment before 2008 in accordance with old Caishuizi [2000] No 49 if it leases or sells that equipment within five years of the purchase date, regardless of whether that lease or sale takes place before, on, or after 1 January 2008, according to Circular 69.

♦ by Jinsong Hu, BDO China

China-Barbados Protocol Comes into Effect

The protocol to the China-Barbados double tax treaty, signed on 10 February 2010, came into force on 9 June, after the competent authorities of the two countries had completed all legal procedures necessary for its entry into force, China's State Administration of Taxation (SAT) confirmed on 28 June, by the issue of Guoshuifa [2010] No 64. The protocol will have effect with respect to income arising after 2010.

The protocol to the Barbados-China income tax treaty, which was signed on 15 May 2000, provides an important change in the capital gains article and updates provisions relating to the definition of 'resident', the income tax treatment of dividends, the methods for the elimination of double taxation, and exchange of information. It also includes an article regarding the application of domestic anti-avoidance law.

Capital Gains

The protocol gives China the right to tax two types of Chinese-source capital gains generated by residents of Barbados from equity transactions. The first type is a transaction in which gains accrue to a resident of Barbados from the disposal of shares, participations, or other rights over the capital of a Chinese company. China will be eligible to tax the capital gains if the recipient of the gains, at any time during the 12-month period preceding the equity transaction, had a direct or indirect participation of at least 25% in the capital of that Chinese company. The second type of transaction is one where gains accrue to a resident of Barbados from the sale of shares deriving more than 50% of their value, directly or indirectly, from immovable property situated in China.

Previously, China did not have the right to tax any capital gains derived by residents of Barbados from the disposal of shares in Chinese companies under the 2000 treaty.

Dividends

A Barbados-resident company that receives dividends from a Chinese company is subject to income tax in China, according to the protocol. The rate of tax is 5% of the gross amount of the dividends if the Barbados company is the beneficial owner of the dividends and holds directly at least 25% of the capital of the Chinese company; otherwise, the tax is 10% of the gross amount of the dividends in all other cases.

Under the previous provision of the treaty, the withholding tax rate for dividends received by a resident company in Barbados was only 5% if it was the beneficial owner of the dividends.

Anti-avoidance legislation

The protocol allows China and Barbados to implement their own domestic laws regarding the prevention of

tax evasion and avoidance as long as the domestic laws do not give rise to taxation contrary to the tax treaty.

Comment

Many companies have treated Barbados as a gateway for investment into China, principally because of the favourable capital gains and dividend articles in the 2000 tax treaty. Under the protocol, China is given the right to levy income tax on the two types of Chinese-source capital gains derived by residents of Barbados referred to above.

Because of the protocol as well as the recent changes in Chinese domestic tax legislation, companies that indirectly own Chinese subsidiaries through holding companies in Barbados should now evaluate the potential tax impact of their corporate structure and when necessary consider reasonable restructuring to keep their structure optimised from a worldwide tax standpoint.

For example, a resident of Barbados that owns 25% or more of the shares in a Chinese-resident company and sells part or all of the shares to any third party is not subject to income tax in China on capital gains from the equity transaction if the gains arise in 2010, but will be so liable if they arise in 2011 or subsequently.

A Barbados company must obtain approval from the Chinese tax authorities regarding a tax exemption for capital gains arising from the sale of shares in a Chinese-resident company, according to Guoshuifa [2009] No 124, issued by the SAT on 24 August 2009. To obtain the approval, supporting documents must be provided to establish the status of a tax resident of Barbados.

From a practice standpoint, Barbados companies that do not have or seldom have economic substance may have difficulty in obtaining approval of tax-treaty treatment from the Chinese tax authorities. The current tax legislation does not provide a standard for determining how much substance is needed to qualify for treaty benefits; therefore, local tax authorities play an important role in deciding whether those benefits apply.

♦ by Jinsong Hu, BDO China

VAT AND BUSINESS TAX

SAT Issues New VAT Rules for General Taxpayer Verification

China's State Administration of Taxation (SAT) on February 10 issued new VAT rules for general taxpayer verification and administration (SAT Decree No. 22), which replace the old general taxpayer verification rules dating back to March 15, 1994.

According to Decree 22, VAT payers whose annual taxable sales amounts exceed the standard set by the Ministry of Finance and the SAT for small-scale taxpayers must apply to the competent tax authorities for verification of general taxpayer qualification unless otherwise stated in article 5 of the decree. VAT payers whose annual taxable sales do not meet the above standard and new VAT payers may also submit an application to the competent tax authorities for verification.

The annual taxable sales amount refers to an aggregate amount of taxable sales (those sales that are exempt from VAT are not excluded). Article 5 of Decree 22 provides that the following taxpayers cannot apply for the general taxpayer verification:

- individuals other than industrial or commercial households;
- entities that are not enterprises but elect to be small-scale taxpayers; and
- enterprises that have casual taxable activities but elect to be small-scale taxpayers.

Decree 22 says that a taxpayer that has been approved as a general taxpayer will not be reclassified as a small-scale taxpayer unless otherwise stipulated by the SAT.

The current VAT regime provides two types of VAT payers: general taxpayers and small-scale taxpayers. A small-scale taxpayer is a manufacturer or taxable service provider (including a manufacturer or taxable service provider who is also a distributor or retailer but derives more than 50 percent of its total annual taxable sales amount from manufacturing or service sales) whose annual taxable sales amount does not exceed CNY 500,000 (about $73,300) or any other taxpayer whose annual taxable sales amount is not greater than CNY 800,000 (about $117,200). All other VAT payers are known as general taxpayers.

Under the applicable VAT system, general taxpayers are subject to a 13 percent VAT rate for designated goods and a 17 percent VAT rate for all other goods and all taxable services. Generally, they are allowed to deduct input VAT from output VAT. Small-scale taxpayers are subject to VAT at 3 percent of turnover (excluding the VAT amount), and no input VAT deductions are permitted.

Except for those set out in article 5 of Decree 22, a VAT payer whose annual taxable sales amount is more than the standard will be subject to the 13 percent or 17 percent VAT rate but will not be allowed to deduct input VAT from output VAT or issue VAT special invoices without applying for the general taxpayer verification, according to the VAT rules.

♦ by Glen Wei, China Desk, BDO USA, LLP (This article was previously published in Tax Notes International by Tax Analysts.)

China Provides Tax Benefits for Energy Service Companies

The General Office of the Chinese State Council on April 2 issued Guobanfa [2010] No. 25 (Circular 25), which provides preferential tax treatment for companies that provide energy-saving services.

Companies that contract to perform energy management projects that comply with the related tax rules are exempt from enterprise income tax for three years, beginning from the tax year in which they generate their first revenue from business operations, and are eligible for a 50 percent EIT reduction for the following three years, the circular says.

Energy management companies also are provisionally exempt from business tax on the taxable revenue they derive from their contracted energy management projects, and are exempt from VAT on zero-consideration transfers of assets (arising during the implementation of those projects) to energy utility entities.

After their energy management contracts expire, the companies are not required to recognize income from the transfer of assets (arising during the implementation of their contracted energy management projects) to the energy utility entities, and those assets are deemed to have been completely depreciated or amortized.

Energy utility entities can also deduct from taxable income reasonable payments to energy management companies in accordance with the energy management contracts in the current tax year.

Circular 25 states that guidelines for the tax treatment will be formulated by the Ministry of Finance, the State Administration of Taxation, and other related departments.

In addition to the aforementioned tax benefits, Circular 25 also offers energy management companies support in the form of financing, government subsidies, and so on.

Under the energy management mechanism, energy management companies contract with their customers to provide diagnoses, financing, improvements, and other energy management services, and they earn reasonable investment returns depending on energy savings.

♦ by Glen Wei, China Desk, BDO USA, LLP (This article was previously published in Tax Notes International by Tax Analysts.)

ACCOUNTING AND AUDIT

MOF Release of November 2009 Regarding the Audit of Hong Kong-Listed Chinese Companies

According to a government release from November 2009: “Because the mainland accounting profession began developing at a late stage and its foundation was weak, there is still a big difference between its overall quality and the economic demands of China and the quality of the global accounting profession.” In order to overcome this state, China plans to establish 5 to 10 large CPA firms and about 200 medium-sized ones within the next 5 years.

Due to the facts stated in the above extract, China has a strong need to develop the accounting profession within the next few years. Also, a large number of Chinese privately held and state-owned companies are listed on the Hong Kong Stock Exchange.

One of the steps is to offer possibilities for accounting firms to audit large internationally operating and internationally listed Chinese mainland companies. The scheme introduced by the head of the Ministry of Finance accounting department Liu Yuting treats this as an act of development. First, some accounting firms will act as pilots in the matter. The MOF released several obligatory qualifications for the participation:

- a turnover of at least CNY 300 million (at least 75% of which from auditing);
- at least 30 publicly listed clients;
- at least 300 Chinese certified public accountants; and
- no partner to have more than 25% of the shares in the firm.

Furthermore, the accounting firm needs to have a Hong Kong based counterpart or belong to a network with a Hong Kong-based member firm.

Sixteen accounting firms have applied for the scheme; however, there is no assurance that all of them will get be allowed to participate in the pilot programme.

In the programme, Chinese-based accounting firms will audit Chinese companies with “H” Shares and Hong Kong-based auditors will audit Hong Kong companies operating in China. Therefore there will be a win-win situation and opportunities on both sides.

Liu Yuting pointed out that it will be a further step in the development of large Chinese accounting firms operating all over the world. In cooperation with Hong Kong, both of them can strengthen their business and offer services to Chinese enterprises worldwide.

♦ by Maximilian Paulsen, China Desk, BDO Germany

Accounting Treatment of Pharmaceutical R&D Expenses

With a 17% growth rate for the industry, China has become one of the most important nations for pharmaceutical manufacturing. In western pharmaceutical industries research and development (R&D) are the key activities; in comparison, the Chinese pharmaceutical industry has less innovation and investment in R&D. The central government is encouraging R&D through investment and other incentives in an effort to build a world-class pharmaceutical industry. The Chinese Accounting Standard (CAS) 6 'intangible assets' deals with the accounting treatment of R&D expenses, and shows significant similarity with the International Accounting Standard (IAS) 38.

Industry of Growing Importance

The pharmaceutical industry is one of the leading industries in China.

The domestic pharmaceutical market is highly fragmented and inefficient. Most often cited adverse factors include a lack of protection of intellectual property rights, a lack of visibility for drug approval procedures, a lack of effective governmental incentives and poor corporate support for drug research.

Even so, the industry environment has been transformed for the better over the last ten years. Entry to the WTO has brought a stronger patent system, medical insurance is now more widespread and pharmaceutical-related regulations have been stiffened. China has now become the fifth largest pharmaceuticals market in the world.

Increasing R&D

With the expansion of China's economy, one of the key objectives on the central government's agenda is to remodel the country from being the 'world's factory' to a world R&D base.

Therefore new regulations have been issued to provide for incentives to encourage R&D activities in China.

For pharmaceutical companies income tax incentives are available for carrying out R&D in China. Namely, companies classified by the authorities as high/new technology enterprises enjoy a reduced corporate income tax of 15%, instead of the normal 25%.

Further the government drug-pricing policy prefers innovative drugs in order to stimulate investment in R&D activities.

Even the patent system has caught up with the expansion of the pharmaceutical industry. A revision as of October 2009 brought the existing law closer to common practice in Europe and the United States.

As a result an increasing number of domestic companies have been placing more emphasis on R&D.

Expenditure on R&D has to be recognised as an intangible asset in the financial statements under certain conditions.

Public Chinese pharmaceutical companies are required to adopt Chinese Accounting Standards (CAS) as of January 2007; these are converging significantly with IFRS. CAS 6 regulates the accounting treatment of R&D expenditure, and is described below.

Research and Development Process

CAS 6 follows IAS 38's concept of the selective recognition, i.e. it prohibits the recognition of research expenditure as an intangible asset and orders the recognition of development expenditure as an intangible asset when it meets the recognition criteria.

The R&D process is divided into phases. Illustration 1 shows the distinction between basic research, applied research and development.

Illustration 1: R&D process

Research is an original and planned investigation undertaken with the aim of gaining new scientific or technical knowledge and understanding (CAS 6.7, IAS 38.8). Examples are basic and applied research as well as the search for product and process alternatives. Research expenditure may not be recognized as an intangible asset (CAS 6.8, IAS 38.54).

Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use (CAS 6.7, IAS 38.8).

Recognition Criteria for Development Expenditure

CAS 6 regulates the accounting treatment of intangible assets. An intangible asset is an identifiable non-monetary asset without physical substance (CAS 6.3, IAS 38.8). An asset is identifiable in the definition of an intangible asset when it is separable, i.e. is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, or arises from contractual or other legal rights (CAS 6.3, IAS 38.11f.).

Identified intangible assets have to be tested for the recognition criteria. At first CAS 6 defines abstract recognition criteria for all intangible assets. According to CAS 6.4 (IAS 38.21) an intangible asset shall be recognised if, and only if, it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity and the expenditure of the asset can be measured reliably. For development expenditure the abstract recognition criteria are substantiated in CAS 6.9 (IAS 38.57) (compare Illustration 2).

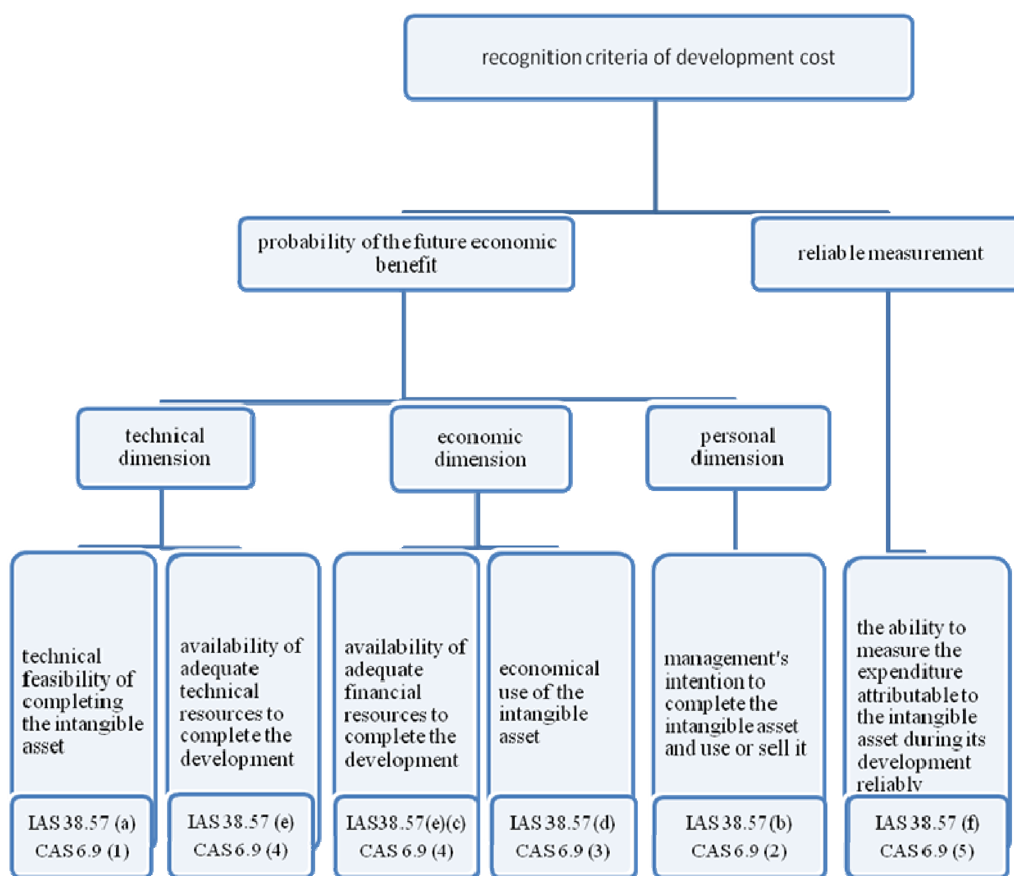


Illustration2: recognition criteria for development expenditure

For development expenditure it is difficult to determine the probable future economic benefit, therefore this abstract recognition criterion is substantiated by four specific recognition criteria. A fifth specific recognition criterion substantiates the abstract recognition criterion of the reliable measurement.

The criterion of technical feasibility (CAS 6.9 (1), IAS 38.57 (a)) of the intangible asset is a temporal criterion that defines the point of time during the R&D-process to which the development has progressed so far that it can be assumed that the intangible asset can be completed.

For innovative drugs this criterion is fulfilled at the moment of their approval by the relevant authority. Medicine for the Chinese market must be approved by the Chinese State Food and Drug Administration (SFAD). This authority oversees all drug manufacturing, trade and registration. Its regulations follow the model of the US Food and Drug Administration (FDA).

The approval of an innovative drug takes place at the end of a development process. This criterion considerably limits the range of recognisable development expenditure, because all expenditure before the approval has to be recognised as an expense.

However, the technical feasibility depends on the innovative degree of the development project.

Although several Chinese pharmaceutical companies have established an R&D infrastructure, their primary focus is still directed towards improving existing technologies or developing generic versions of new drugs.

The imitation of a well-known active substance is relatively simple. Further simplified approval requirements are required for generic drugs. So development projects for generic drugs can already be seen as technically realisable at the beginning of the development process.

There must be a clear intention for the completion and utilisation of the intangible asset (CAS 6.9(2), IAS 38.57 (b)). This intention can be indicated by a development project plan.

Furthermore a demonstration of the probable future economic benefit is required (CAS 6.9 (3), IAS 38.57 (d)). At first a market for the medicine must exist, which can be shown by appropriate market studies.

Then the future economic benefit can be demonstrated by a positive present value of the expected future revenues from the new medicine.

A further recognition criterion is the availability of adequate technical, financial and other resources to

complete the development and to use or sell the intangible asset (CAS 6.9 (4), IAS 38.57 (e)).

Technical resources are adequate, if the equipment of the project corresponds to the project plan regarding the accommodation, machines, technical devices etc.

The development of a medicine and its marketing requires considerable financial means. The evaluation of financial resources can take place on the basis of a business plan.

Other resources are to be understood as a retention basin, relating to the number and qualification of the relevant employees, for instance.

The reliable measurement of the expenditure (CAS 6.9 (5), IAS 38.57 (f)) requires a functional expenditure control system. It is important to separate research expenditure from development expenditure; otherwise all expenditure will be accounted as an expense.

♦ by Jingcao Wang, China Desk, BDO Germany

COMPLIANCE

Compliance on the Rise – China Extends Fight against Corruption

Rising corruption in China is a problematic social phenomenon of which Chinese citizens as well as the Chinese government are surely aware. Foreign companies investing in China need to bear in mind that despite significant reforms and the tremendous economic development of the country, corrupt structures remain and the legal system is still under development. According to the Corruption Perception Index (CPI) published by Transparency International (TI) in 2009, China ranks at position 79 on a list of 180 countries ranked according to their locally perceived corruption. On a scale ranging from 0 = low perceived corruption to 10 = high perceived corruption, China receives a rather mediocre assessment with an index of 3.6.

The government has been trying for years to diminish the negative consequences that result from corrupt structures, especially in the public sector. It has introduced complex anti-corruption campaigns and has passed laws to fight corruption. However, these steps seem to have had little effect, as the perception is that these laws were only enforced against lower-ranking officials and only occasionally to higher-ranking ones. Additionally, in recent decades, due to an immature legal system, the problem has apparently been looked at and approached in a rather ideological way rather than juridically. Therefore a stringent pattern of prosecution is not perceptible.

Nonetheless - taking into account recent news from China - this seems to be changing. The urge to take consistent measures to combat corruption is felt by the government and judgments are severe. To mention some examples, only recently the high-ranking inspector Guo Jingyi from the Ministry of Commerce was sentenced to death for receiving CNY 8.45 million (1.24 million dollars) in bribes. The Tianjin No 1 Intermediate People's Court has sentenced a high-ranking former vice-chair of the Standing Committee of the People's Congress of Jilin Province to death for embezzling approximately USD 900 000. Apparently, 3000 officials have also been penalised for fraudulent acts in connection with the government's economic stimulus programme. However, the government does not stop at punishing officials. A private individual who has fallen foul of the new anti-corruption drive is Huang Guangyu, once reputed to have been the richest man in mainland China and the former chairman of Gome, a Chinese electronics supplier. He apparently amongst others has been found guilty of insider trading and bribery and has been sentenced to 14 years in prison.

According to a recent statement by the Chinese Xinhua news agency, China's Supreme People's Prosecution Service and the Ministry of Public Security have issued new rules regarding the prevention of insider trading. This suggests that the government is increasingly seeking to spread its anti-corruption measures to the private sector.

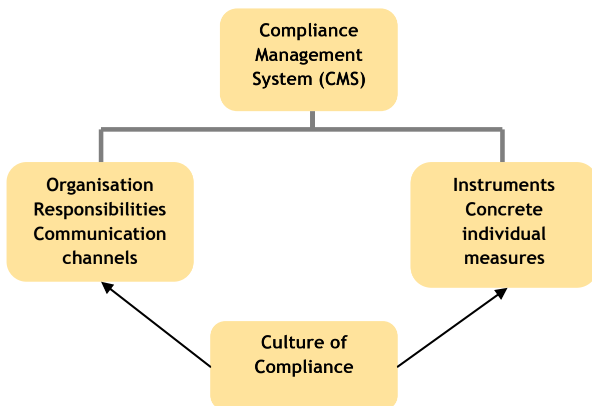
Companies are able to confront risks of corruption by implementing compliance measures. Compliance on the corporate level includes the idea of how a company can assure that it as well as its employees act lawfully and how the risk of regulatory offences or criminal acts can be reduced.

In the United States, where the concept of compliance originates, corruption or compliance issues are seemingly naturally discussed at all levels and the focus is on how an ideal compliance organisation can be established. A similar development can be observed in Germany. Not least because of problems resulting from corruption, there has been a lively public discussion on compliance issues in German society. Consequently, German companies have no choice but to handle the problems, especially in order to minimise liability risks, including those with respect to the management. Given the increasing controls by the Chinese government which are outlined above, this means German companies as well as other foreign companies are urged to assure compliance also in their Chinese subsidiaries.

In this context the term Compliance Management System (CMS) has been formulated. One possible structure of such a CMS would be the establishment of a so-called Compliance Organisation and Compliance Instruments. On the one hand, the organisation represents the overall structure of the CMS, including the establishment of communication channels as well as the allocation of responsibilities. On the other hand

the instruments can be regarded as individual measures, such as adherence to the law, internal guidelines, codes of conduct and anti-corruption guidelines as well as the establishment of compliance training. Another decisive feature of a functioning CMS is the 'tone at the top'. This includes the way a company is run, which values are prevalent and whether the management serves as a model.

Certainly, corruption is only one possible issue companies acting in China may approach with such a CMS. Anti-money laundering, product piracy etc are other elements that are topics to be further addressed in this context.



Discussing mere awareness raising for the need for compliance in Chinese companies, taking into account the abovementioned ideas, is inevitable. Awareness and the creation of concepts that go in the direction of our understanding of compliance are, however, currently still in the development stage in China. As shown by their development of a Chinese Corporate Governance Code, the Chinese authorities are prepared to adopt Anglo-Saxon concepts at least in part. In any case, it seems natural that the very different Chinese culture will continue to influence the features and the implementation of Compliance Management Systems in China. Foreign companies operating in China need to bear in mind that the implementation of their CMS might not as easily be copied to the Chinese environment. A simple example would be the development of a code of conduct. For example, if Chinese employees are told to abide by a written code of conduct, they will not necessarily do so. Chinese may often not regard a written document as the highest authority, as Germans may. Therefore, the most important step foreign companies need to take in order to create a common ground of communication, is to give employees substantial information about what the company's goals and values are and to explain why compliance is so important. Rules and internal controls that are enforced will then be more respected and adhered to.

Certainly the implementation and enforcement of an existing CMS in Chinese companies and against the Chinese cultural background is a great challenge. Nonetheless compliant business in China is inevitable.

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