



Timing and calculation of withholding tax on loan interest, guarantee fees, rentals and capital gains of foreign companies clarified

Regulation discussed in this issue:

- Announcement on Corporate Income Tax Administration of Non-resident Enterprises, SAT Announcement [2011] No. 24 (Announcement 24), issued by the SAT on 28 March 2011, effective from 1 April 2011.

Background

In Announcement 24, the State Administration of Taxation (SAT) clarifies the timing and calculation method of the Corporate Income Tax (CIT) treatment of loan interest, rentals, royalties, capital gains and guarantee fees derived by non-resident enterprises from China. Many of the rules contained in Announcement 24 are similar to those on the same issues under the old Foreign Enterprise Income Tax (FEIT) Law. With the issuance of Announcement 24, the new CIT Law has “caught up” with the old FEIT Law in the sense that many issues that used to be addressed by the old law, but not the new law have now been dealt with by Announcement 24. Announcement 24 is effective from 1 April 2011.

The key points of Announcement 24 and our comments on them are set out below. Appendix A contains a summary of these key points:

1. Accrued loan interest, rentals and royalties

Where a resident enterprise accrues loan interest, rentals or royalties payable to a non-resident enterprise in its annual account and claims deduction on those expenses for CIT purposes, the resident enterprise should withhold and remit to the Chinese tax authority CIT payable by the non-resident enterprise on its income in that year. This rule applies to situations where a resident enterprise has entered into a contract for the payment of such expenses and has not paid them by the contract due dates or has altered or amended the contract to defer the payment of such expenses.

If such accrued expenses are not recorded as costs or expenses in one go, but capitalised as the cost of an asset or a pre-operating expense of the resident enterprise and amortised over a period of several years after the asset is put into use or the production operation begins, the resident enterprise should withhold and remit to the Chinese tax authority CIT payable by the non-resident enterprise on the whole amount of those expenses in the year in which the related expenses are capitalised as an asset or pre-operating expense by the resident enterprise rather than as and when the capitalised amount is amortised.

If the resident enterprise pays the abovementioned incomes before the contract due dates, the resident enterprise should withhold and remit to the Chinese tax authority CIT on the actual payment dates. However, it is not clear from Announcement 24, if an advance payment is capitalised as an asset or pre-operating expense, as to whether CIT should still be due on the actual payment due date or the date on which the asset is put into use or the operation begins.

The abovementioned rules are similar to those contained in the circulars, Guo Shui Han [1998] No. 757 and Guo Shui Han [1999] No. 788, under the old FEIT Law.

The abovementioned rules should only cover situations where the non-resident enterprises do not have any establishments in China or where the non-resident enterprises have establishments in China, but the relevant income is not effectively connected with those establishments. Announcement 24 does not address the latter situation except in the case of rentals derived from the letting of the immovable properties in China, which are discussed in Point 5 of this China alert. However, based on the basic principles underlying the CIT Law, non-resident enterprises with establishments in China should be required to account for their CIT liability based on profits attributed to their establishments and declare and pay the tax in their own right.

2. Guarantee fees

Where a non-resident enterprise derives guarantee fees from China, the non-resident enterprise should calculate and pay CIT on the guarantee fees using the same rate as loan interest in accordance with the CIT Law i.e. 10 percent. "Guarantee fees" in this context refer to guarantee fees or fees of a similar nature that are paid or borne by a resident enterprise in China for accepting guarantees from a non-resident enterprise in the course of economic activities such as lending and borrowing, buying and selling, transportation of goods, contracted processing, leasing and contracted projects..

The abovementioned rules are similar to those contained in the circular, Cai Shui Zi [1998] No. 1, under the old FEIT Law.

It is important to note that Announcement 24 does not state that guarantee fees are of the same nature as or of a similar nature to loan interest. It is, however, not clear from Announcement 24 as to whether SAT classifies guarantee fees as "other income" under Article 19 of the CIT Law. The announcement only provides that the same tax rate as applicable to loan interest should apply to guarantee fees.

As such, there is a risk that tax treaty relief that applies to loan interest will not necessarily be available to guarantee fees. For example, according to the circular, Guo Shui Fa [2010] No. 75, which deals with the interpretation of the China-Singapore tax treaty, loan interest referred to in Article 11 of that treaty should not include guarantee fees independently received by persons other than the creditor under a loan (para 4(2)(2) refers). This means that the reduced withholding rate of seven percent under that tax treaty may not be available to guarantee fees of such nature although under the domestic CIT Law, both the loan interest and guarantee fees are subject to the same rate of

10 percent. In practice, it is, therefore, advisable to clarify this issue with the tax authority in charge in advance.

3. Income from transfer of land use rights

Where a non-resident enterprise transfers a land use right in China, it should pay CIT on the excess of the proceeds from the transfer over the tax base of the land use right. This rule will apply where the non-resident enterprise does not have any establishments in China or where it has an establishment in China, but the income from such transfer is not effectively connected with that establishment. The withholding agent in China should withhold CIT payable by the non-resident enterprise.

Announcement 24 does not define the term “tax base” in this context. In principle, it should at least cover the cost of acquiring the land use rights. However, it is not clear if other expenses in connection with the acquisition of the land use rights e.g. stamp duty, should be included as part of the tax base. It is also not clear if depreciation or amortisation charges in the hands of the non-resident enterprises should be taken into account in arriving at the tax base. According to Article 19(2) of the CIT Law, the taxable gains derived by non-resident enterprises from the transfer of properties should be calculated as the excess of proceeds over net asset values.

Announcement 24 does not address the situations where a non-resident enterprise with an establishment in China transfers a land use right in China. Based on the basic principles underlying the CIT Law, the non-resident enterprise should be required to account for its CIT liability based on profits attributed to its establishment and declare and pay the tax in its own right.

The abovementioned rules are similar to those contained in Article 61 of the implementation rules for the old FEIT Law. In this regard, it can be useful to note that Article 61 made reference to “original value” of the properties concerned rather than “tax base”.

4. Lease considerations from finance leases

Where a non-resident enterprise leases a piece of equipment or an article to a resident enterprise under a finance lease, the non-resident enterprise will be liable for CIT on the excess of the lease considerations over the price of the equipment or article as if it were loan interest. “Lease considerations” in this context include the consideration paid for the equipment or article at the end of the term of the lease.

The abovementioned rules apply to non-resident enterprises without establishments in China. Finance leases referred to in this announcement cover arrangements whereby the ownership of the equipment or articles reverts to the resident enterprises in China at the end of the lease term (including arrangements under which the equipment or articles are transferred for a consideration at the end of the lease term).

The abovementioned rules are similar to those contained in the circular, Cai Shui Zi [1982] No. 80 under the old FEIT Law.

Announcement 24 does not specifically address the issue of the timing of the CIT liability of a non-resident enterprise under a finance lease. The announcement does refer to the lease arrangement as one in which the non-resident enterprise derives lease considerations in accordance with the due dates as stipulated in the lease contract. Also given the rule that the excess of the lease considerations over the price of the equipment or article is treated as loan interest, it is reasonable to take the position that CIT will become payable as and when the related lease considerations fall due over the term of the lease. Nevertheless, it is advisable to clarify this issue with the tax authority in charge when dealing with it in practice.

Announcement 24 also does not address the issue as to whether loan interest incurred by the non-resident enterprise in funding the finance lease arrangement is deductible in calculating the taxable income of the non-resident enterprise.

5. Rentals from letting of immovable properties

The CIT treatment of the rental income derived by a non-resident enterprise from the letting of an immovable property in China will depend on whether the non-resident enterprise has an establishment in China. A non-resident enterprise will be treated as having an establishment in China if it assigns its personnel to China or appoints another unit or individual in China to manage the abovementioned immovable property on a daily basis.

Where the non-resident enterprise does not have any establishments in China, it will be liable for CIT on the gross amount of the rental revenues. The tenant will be required to withhold and remit the tax every time it pays or it is due to pay the rentals. Where the non-resident enterprise has an establishment in China, the non-resident enterprise will be required to declare and pay CIT in its own right based on the profits attributed to that establishment.

The abovementioned rules are similar to those contained in the circular, Guo Shui Fa [1996] No. 212 under the old FEIT Law.

6. Returns on equity investments

Where a resident enterprise in China distributes returns on equity investments such as dividends and profit participations to a non-resident enterprise that does not have any establishments in China, the resident enterprise should withhold and remit to the tax authority the CIT payable by the non-resident enterprise on such returns when the resident enterprise passes a resolution on the profit distribution. If the actual payment date is earlier than the date on which the resolution is passed, then the CIT should be withheld and remitted when the payment is actually made.

There were no similar rules on dividends paid to foreign investors by foreign investment enterprises under the old FEIT Law because at that time such dividends were specifically exempt from withholding tax under the FEIT Law.

KPMG observation

The new CIT Law has replaced the old FEIT Law from 1 January 2008 onwards. However, until the issuance of Announcement 24, the CIT Law did not specifically address the issues covered by the announcement, many of which however were dealt with by the old FEIT Law. In the meantime, both the taxpayers and the tax authorities at the local level had to wrestle with many uncertainties and associated risks when they were confronted with these issues. Some tax authorities decided to follow the rules under the old FEIT Law although technically many of them ceased to be effective under the new CIT Law. Announcement 24 has gone a long way to provide clarity in this regard. However, as mentioned above, a number of important questions still remain unanswered. Foreign companies should, therefore, actively engage in discussions with the tax authorities in charge and, where necessary, the Ministry of Finance and SAT, when tackling these problems in reality.

Interestingly, although Announcement 24 contains rules that are intended to interpret and apply the provisions that have long been contained in the CIT Law, the announcement is effective from 1 April 2011 only, rather than retrospectively to 1 January 2008 i.e. when the CIT Law came into force. However, the announcement does state that, for matters that took place before 1 April 2011, but have not been resolved for tax purposes by then, the announcement should still be applicable. It is not clear from Announcement 24

as to the circumstances under which a matter will be considered as having been resolved for tax purposes by 1 April 2011. A possible view is that as long as the tax clearance for the remittance of the dividends, loan interest, guarantee fees, royalties, rentals or capital gains concerned was obtained before 1 April 2011, the matter should be regarded as having been resolved by then.

However, for issues which involve long-established fundamental principles under the domestic law or tax treaties e.g. whether the activities of a non-resident enterprise under a lease of immovable property should constitute an establishment or permanent establishment in China, the tax authority in charge may seek to recover the tax payable by the non-resident enterprise so far as the statute of limitation permits, even if the tax clearance was obtained before 1 April 2011. In practice, it is likely that there will be local variations in the implementation and enforcement of Announcement 24.

Appendix A – Summary of key points of Announcement 24

Income types	Circumstances	CIT treatment
Accrued loan interest, rentals and royalties	Non-resident enterprise without any establishments in China	
	<u>Paid on or after contract due date</u>	
	<ul style="list-style-type: none"> Recorded as costs and expenses when incurred Capitalised as assets or pre-operating expenses when incurred and subsequently amortised 	<ul style="list-style-type: none"> Resident enterprise to withhold CIT payable when resident enterprise accrues and deducts costs or expenses Resident enterprise to withhold CIT payable on whole amount of income when resident enterprise puts assets into use or begins operation
	<u>Paid before contract due date</u>	
	<ul style="list-style-type: none"> Recorded as costs and expenses when incurred Capitalised as assets or pre-operating expenses when incurred and subsequently amortised 	<ul style="list-style-type: none"> Resident enterprise to withhold CIT payable when the payment is made Not clear from Announcement 24
	Non-resident enterprise with an establishment in China	Not addressed by Announcement 24 except for rentals from letting of immovable properties (please see below)
Guarantee fees	Non-resident enterprise without any establishments in China	Resident enterprise to withhold CIT payable at the same rate as loan interest
	Non-resident enterprise with an establishment in China	Not addressed by Announcement 24
Gains from the transfer of land use rights	Non-resident enterprise without any establishments in China	Resident enterprise to withhold CIT payable on the excess of proceeds over tax base
	Non-resident enterprise with an establishment in China	Not addressed by Announcement 24
Lease considerations from finance lease	Non-resident enterprise without any establishments in China	Resident enterprise to withhold CIT payable on the excess of lease considerations over equipment price
	Non-resident enterprise with an establishment in China	Not addressed by Announcement 24
Rentals from letting of immovable properties	Non-resident enterprise without any establishments in China	Resident enterprise to withhold CIT payable on rental revenues every time it pays or is due to pay rentals
	Non-resident enterprise with an establishment in China	Non-resident enterprise to pay CIT in its own right
Returns on equity investments	Non-resident enterprise without any establishments in China	Resident enterprise to withhold CIT when it passes a resolution to declare dividends
	Non-resident enterprise with an establishment in China	Not addressed by Announcement 24

Contact us

Khoonming Ho

Partner in Charge, Tax
China and Hong Kong SAR
Tel. +86 (10) 8508 7082
khoonming.ho@kpmg.com

Beijing/Shenyang

David Ling

Partner in Charge, Tax
Northern China
Tel. +86 (10) 8508 7083
david.ling@kpmg.com

Qingdao

Vincent Pang

Tel. +86 (532) 8907 1728
vincent.pang@kpmg.com

Shanghai/Nanjing

Lewis Lu

Partner in Charge, Tax
Central China
Tel. +86 (21) 2212 3421
lewis.lu@kpmg.com

Hangzhou

Martin Ng

Tel. +86 (571) 2803 8081
martin.ng@kpmg.com

Chengdu

Anthony Chau

Tel. +86 (28) 8673 3916
anthony.chau@kpmg.com

Guangzhou

Lilly Li

Tel. +86 (20) 3813 8999
lilly.li@kpmg.com

Fuzhou/Xiamen

Jean Jin Li

Tel. +86 (592) 2150 888
jean.j.li@kpmg.com

Shenzhen

Eileen Sun

Partner in Charge, Tax
Southern China
Tel. +86 (755) 2547 1188
eileen.gh.sun@kpmg.com

Hong Kong

Karmen Yeung

Tel. +852 2143 8753
karmen.yeung@kpmg.com

Northern China

David Ling

Partner in Charge, Tax
Northern China
Tel. +86 (10) 8508 7083
david.ling@kpmg.com

Vaughn Barber

Tel. +86 (10) 8508 7071
vaughn.barber@kpmg.com

Roger Di

Tel. +86 (10) 8508 7512
roger.di@kpmg.com

John Gu

Tel. +86 (10) 8508 7095
john.gu@kpmg.com

Jonathan Jia

Tel. +86 (10) 8508 7517
jonathan.jia@kpmg.com

Vincent Pang

Tel. +86 (10) 8508 7516
+86 (532) 8907 1728
vincent.pang@kpmg.com

Michael Wong

Tel. +86 (10) 8508 7085
michael.wong@kpmg.com

Irene Yan

Tel. +86 (10) 8508 7508
irene.yan@kpmg.com

Tracy Zhang

Tel. +86 (10) 8508 7509
tracy.h.zhang@kpmg.com

Catherine Zhao

Tel. +86 (10) 8508 7515
catherine.zhao@kpmg.com

Hiroyuki Takahashi

Tel. +86 (10) 8508 7078
hiroyuki.takahashi@kpmg.com

Leonard Zhang

Tel. +86 (10) 8508 7511
leonard.zhang@kpmg.com

Central China

Lewis Lu

Partner in Charge, Tax
Central China
Tel. +86 (21) 2212 3421
lewis.lu@kpmg.com

Anthony Chau

Tel. +86 (21) 2212 3206
+86 (28) 8673 3916
anthony.chau@kpmg.com

Cheng Chi

Tel. +86 (21) 2212 3433
cheng.chi@kpmg.com

Bolivia Cheung

Tel. +86 (21) 2212 3268
bolivia.cheung@kpmg.com

Dawn Foo

Tel. +86 (21) 2212 3412
dawn.foo@kpmg.com

Chris Ho

Tel. +86 (21) 2212 3406
chris.ho@kpmg.com

Sunny Leung

Tel. +86 (21) 2212 3488
sunny.leung@kpmg.com

Martin Ng

Tel. +86 (21) 2212 2881
+86 (571) 2803 8081
martin.ng@kpmg.com

Yasuhiko Otani

Tel. +86 (21) 2212 3360
yasuhiko.otani@kpmg.com

Grace Xie

Tel. +86 (21) 2212 3422
grace.xie@kpmg.com

Zichong Xu

Tel. +86 (21) 2212 3404
zichong.xu@kpmg.com

Jennifer Weng

Tel. +86 (21) 2212 3431
jennifer.weng@kpmg.com

William Zhang

Tel. +86 (21) 2212 3415
william.zhang@kpmg.com

David Huang

Tel. +86 (21) 2212 3605
david.huang@kpmg.com

Amy Rao

Tel. +86 (21) 2212 3208
amy.rao@kpmg.com

Southern China

Eileen Sun

Partner in Charge, Tax
Southern China
Tel. +86 (755) 2547 1188
eileen.gh.sun@kpmg.com

Jean Jin Li

Tel. +86 (755) 2547 1128
+86 (592) 2150 888
jean.j.li@kpmg.com

Jean Ngan Li

Tel. +86 (755) 2547 1198
jean.li@kpmg.com

Lilly Li

Tel. +86 (20) 3813 8999
lilly.li@kpmg.com

Kelly Liao

Tel. +86 (20) 3813 8668
kelly.liao@kpmg.com

Angie Ho

Tel. +86 (755) 2547 1276
angie.ho@kpmg.com

Hong Kong

Ayesha Macpherson

Partner in Charge, Tax
Hong Kong SAR
Tel. +852 2826 7165
ayasha.macpherson@kpmg.com

Chris Abbiss

Tel. +852 2826 7226
chris.abbiss@kpmg.com

Darren Bowdern

Tel. +852 2826 7166
darren.bowdern@kpmg.com

Alex Capri

Tel. +852 2826 7223
alex.capri@kpmg.com

Barbara Forrest

Tel. +852 2978 8941
barbara.forrest@kpmg.com

Ken Harvey

Tel. +852 2685 7806
ken.harvey@kpmg.com

Nigel Hobler

Tel. +852 2143 8784
nigel.hobler@kpmg.com

Charles Kinsley

Tel. +852 2826 8070
charles.kinsley@kpmg.com

John Kondos

Tel. +852 2685 7457
john.kondos@kpmg.com

Curtis Ng

Tel. +852 2143 8709
curtis.ng@kpmg.com

Kari Pahlman

Tel. +852 2143 8777
kari.pahlman@kpmg.com

John Timpany

Tel. +852 2143 8790
john.timpany@kpmg.com

Christopher Xing

Tel. +852 2978 8965
christopher.xing@kpmg.com

Karmen Yeung

Tel. +852 2143 8753
karmen.yeung@kpmg.com

Jennifer Wong

Tel. +852 2978 8288
jennifer.wong@kpmg.com

kpmg.com/cn

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