



Businesses required to withhold IIT on certain gifts made to individual customers / targets

Regulation discussed in this issue:

- Circular of the Ministry of Finance and the State Administration of Taxation on Individual Income Tax issues in connection with gifts made by enterprises for sales promotion and business development, Cai Shui [2011] No. 50, (Circular 50), issued on 9 June 2011

Background

The Ministry of Finance (MoF) and the State Administration of Taxation (SAT) jointly issued Circular 50 on 9 June 2011 to deal with the obligation of businesses to withhold Individual Income Tax (IIT) on gifts made to individual customers or targets for sales promotion and business development purposes. Circular 50 shall take effect from the date of release.

The salient points of Circular 50 and our comments regarding them are outlined below:

1. What types of businesses will be covered by Circular 50?

Circular 50 applies to enterprises and units that give cash, expense vouchers, articles, services (hereinafter referred to as "gifts") to individuals in the form of discounts / concessions, presents, lotteries etc. Enterprises and units referred to above include enterprises, institutions, social bodies, enterprises wholly owned by individuals, partnerships and sole traders.

2. Under what circumstances will IIT liability not arise?

No IIT liability will arise when enterprises make gifts in the process of selling merchandise or products or providing services in the following situations:

- i. Enterprises sell merchandises or products or provide services through discount or concession
- ii. At the same time as selling merchandises or products or providing services, enterprises make gifts. For example, telecommunications enterprises give free call charges or free access charges to individual

buyers of mobile phone handsets or give free mobile phone handsets to individual buyers of call services

- iii. Enterprises reward individuals with gifts based on patronage points where the accumulated purchases have reached certain magnitude.

3. Under what circumstances will IIT liability arise so that the enterprises making the gifts will have to withhold and remit the tax?

In the following situations where enterprises make gifts to individuals, the individuals should account for IIT and the enterprises making the gifts should withhold and remit the tax:

- i. In activities such as business promotion or advertising, enterprises take the opportunity to give gifts to individuals other than their own. In that case, the individuals will be liable for IIT on the gifts under the "other income" item at a rate of 20 percent
- ii. In annual conferences, seminars, ceremonies and other activities, enterprises give gifts to individuals other than their own. In that case, the individuals will be liable for IIT on the gifts under the "other income" item at a rate of 20 percent
- iii. Enterprises give extra opportunities to individual customers to take part in lotteries when the accumulated purchases of the customers have reached certain magnitude. In that case, the individuals will be liable for IIT on the gifts under the "occasional income" item at a rate of 20 percent.;

4. How will the value of the gifts be determined for IIT purposes?

Where the gifts are products produced or services generated by the enterprises, the market sale prices of the products or services will be used to determine the taxable income of the individuals; where the gifts are merchandises or services purchased from other parties, then the actual purchase prices of the merchandises or services will be taken into account in arriving at the taxable income of the individuals.

KPMG observations

The practice of business promotion by means of customer gifts has recently received a lot of attention from the Chinese authorities, not least the tax administration. This is because the issues involved are numerous including tax compliance, anti-money laundering, foreign exchange controls and consumer protection.

As far as taxation is concerned, Circular 50 has given more clarity to certain aspects of IIT. It appears that the basic principle underlying the rules contained in Circular 50 is that if the gifts can be identified with specific current or past transactions, then no IIT liability will arise. Hence Circular 50 states that gifts given as discounts / concessions, gifts accompanying products and services and point-based gifts are not subject to IIT; otherwise, IIT liability will arise. Hence Circular 50 states that gifts given in promotion activities and seminars are taxable. The rule on the gifts given through lotteries is interesting because although such gifts can be identified with past transactions through a point system, Circular 50 still treats them as taxable. Perhaps the apparent exception to the basic principle in the case of lotteries is due to the opaque nature of such method. It should be noted that although IIT is the liability of the individuals concerned, commercially, businesses will end up bearing the tax costs.

IIT, however, is only one of the many tax issues that businesses have to deal with when it comes to business promotion gifts. Firstly, the Value Added Tax (VAT) regulations contain rules on deemed sales whereby a gift can be treated as a sale of the businesses making the gift. According to Article 4(8) of the Implementation Rules for VAT Provisional Regulations, the gifting of an

enterprise's own or externally purchased goods to other units or individuals for no consideration shall amount to deemed sales of that enterprise. In that case, the parties making the gifts will have to account for VAT at a full rate on the deemed sales. Alternatively, Article 10(1) of VAT Provisional Regulations provides that input tax on goods used for non-VAT items will not be creditable. Either way, businesses will have to bear the additional VAT costs. On the other hand, the circular, Guo Shui Han [2010] No. 56, reinstates the rule in an earlier circular, Guo Shui Fa [1993] No. 154, that where a taxpayer sells goods at a discount, and the sales price and discount are separately stated on the same invoice, VAT may be levied on the discounted amount. As such, where it is permitted by operations and supportable by the underlying economic substance, a transaction can be structured in such a way as to mitigate the deemed sales exposures.

Regarding Corporate Income Tax (CIT), Article 25 of the Implementation Rules for CIT Law states that where an enterprise uses goods, assets or services for purposes of donations / gifts, sponsorships, advertisements or samples, it will be deemed as selling the goods, transferring the assets or providing the services. Alternatively, the costs of the gifts will not be deductible as they are not directly related to the earning of revenue of the enterprise in accordance with Article 27 of the Implementation Rules for CIT Law. Either way, businesses will end up bearing the tax costs associated with the gifts. However, the circular, Guo Shui Han [2008] No. 875, provides that where an enterprise sells its merchandises as a package using a buy-one-get-one-free method, it will not be regarded as making a donation or gift. Instead, the enterprise shall attribute the total sales price to the components in the package of merchandises at a ratio based on the respective fair values of the components. Again, there is some scope for tax planning in order to mitigate the deemed sales exposures for CIT purposes.

However, the tax issues can become very complicated where the deemed revenue / income rules in the IIT, VAT and CIT regulations interact. Adding to the complexity of the issues is the fact that there is a wide variety of sales promotion models in operation in real life, including point systems, gift vouchers and pre-paid cards, and many of these sales operations are cross border or in multiple locations within China or in and outside China. Tax regulations tend to lag behind the commercial developments in this regard. Therefore, local variations in the IIT, CIT and VAT treatments of sales promotion activities are not uncommon. For example, local circulars, such as Inner Mongolia Announcement [2010] No. 1, Hebei circular Ji Guo Shui Han [2009] No. 247, Sichuan circular Chuan Guo Shui Han [2008] No. 155 and Guangdong circular Sui Guo Shui Fa [2003] No. 287, prescribe tax treatments for transactions specific to their locations. Increasingly, sales promotion activities are an area that tax authorities will focus on during tax audits.

If the tax planning in relation to sales promotion gifts is not carried out properly, one of the worst case scenarios would be that the businesses will have to bear all the major taxes in relation to the gifts. Taking a gift with a value of RMB 100 as an example, the total additional tax costs can amount to approximately RMB 53 (i.e. 53 percent of the value of the gift) as illustrated below:

	RMB	RMB
CIT on deemed sales 100 x 25%		25
VAT on deemed sales 100 x 17%	17	
IIT on deemed income 100 x 20%	<u>20</u>	
Total VAT and IIT	37	
CIT deduction 37 x 25% (note 1)	<u>(9)</u>	<u>28</u>
Total net tax costs		<u>53</u>

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Note 1: Assume VAT and IIT are deductible in calculating taxable income for CIT purposes.

Therefore, it is increasingly important that businesses take a hard look at their sales promotion model and take action to mitigate potential exposures.

Please note that KPMG China will organise a series of workshops on this topic in different cities across China in the near future and will notify our clients of these events in due course. If you would like to find out more about this topic or related events, please do not hesitate to speak with your local KPMG contacts in China.

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

Abe Zhao

Tel. +86 (10) 8508 7096
abe.zhao@kpmg.com

Catherine Zhao

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

Hiroyuki Takahashi

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

Leonard Zhang

Tel. +86 (21) 2212 3350
leonard.zhang@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 M. Lau

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

Jennifer Wong

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

Christopher Xing

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

Karmen Yeung

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

kpmg.com/cn

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