



## Clearer rules on benchmarking of inter-company lending to financial institutions

### Regulation discussed in this issue:

- [Announcement on Certain Corporate Income Tax Issues, SAT Announcement \[2011\] No. 34 \(Announcement 34\), issued by the State Administration of Taxation on 9 June 2011, effective from 1 July 2011](#)

### Background

The State Administration of Taxation (SAT) has issued Announcement 34 on 9 June 2011 to deal with certain Corporate Income Tax issues. In particular, Announcement 34 sets out guidelines on assessing if the interest rate for an inter-company loan is in line with loans from financial institutions. Circular 34 will take effect from 1 July 2011.

The key points of the provisions on inter-company lending in Announcement 34 and our comments on them are set out below:

#### **1. Can a corporation deduct interest paid on inter-company loans and if so, to what extent?**

According to Article 38 of the Implementation Rules for Corporate Income Tax (CIT) law, interest expenses incurred by non-financial institutions on loans from non-financial institutions to the extent that they do not exceed the amounts calculated by reference to the interest rates applicable to loans of the same period and category made by financial institutions are deductible for CIT purposes.

#### **2. How can a corporation prove that its loan expenses are in line with those associated with loans from financial institutions?**

Under Announcement 34, taxpayer is required to provide *Statement on the Interest Rate Applicable to Loans of the Same Period and Category Made by Financial Institutions* ("Statement on Interest Rate") to the tax authority in charge when it first pays the interest on inter-company loan in accordance with the contract and claims deduction of the interest expenses for CIT purposes to prove the reasonableness of its interest expenses incurred.

The abovementioned Statement on Interest Rate shall include information on the interest rate for the same period and category of loan made by any financial institution of the province where the taxpayer is located when the inter-company loan agreement is concluded.

### **3. What qualifies as “financial institutions” for purposes of Announcement 34?**

“Financial institutions” as described in Announcement 34 refer to the financial enterprises that are permitted to carry out loan business, such as commercial banks, finance companies and trust companies.

### **4. How to identify “interest rate for the same period and category of loan”?**

“Interest rate for the same period and category of loan” refers to the interest rate applicable to the loans made by the financial institutions under basically the same conditions in respect of terms, amount, guarantee, credit worthiness of the borrower, etc. Such interest rate can be the average interest rate applicable to the loans of the same period and category released by the financial institutions or the actual interest rate applicable to specific loans made by financial institutions to certain borrowers.

### **5. How do the rules in Announcement 34 interact with the thin capitalisation rules in the CIT Law?**

Basically, the rules in Announcement 34 are complementary to the thin capitalisation rules in the CIT Law in respect of the deductible interest expenses for CIT purposes.

Under the thin capitalisation rules, interest paid by related-party debt in excess of the prescribed debt-equity ratios (5:1 for financial institutions and 2:1 for other enterprises) would be disallowed as deduction for CIT purposes, unless the amount, rate, and terms of the debt is proven to be arm’s length, or the domestic lender is subject to a higher CIT rate than the borrower. In other words, the thin capitalisation rules look at a broad portfolio of related-party debt investment in the enterprise rather than the rate and terms of a specific loan.

Under Announcement 34, taxpayers would need to scrutinise its loans items by items, both related-party and unrelated, and regardless of the amount of the borrowing or its weight in the overall asset base.

### **6. Whether Announcement 34 will apply to entrusted loans via financial institutions?**

On the face of it, Announcement 34 should not apply to entrusted loans via financial institutions since the loans will generally be made by financial institutions to companies although the fund generally will come from other companies within the same group. However, if the tax authorities take a substance over form approach, the principle underlying Announcement 34 can still be invoked to challenge the deduction of loan interest under entrusted loans. In practice, however, there might be temptation to understate rather than overstate loan interest for, among other reasons, Business Tax (BT) purposes, as mentioned in Point 9 below.

### **7. Whether the rules in Announcement 34 apply to loans made by individuals to enterprise?**

According to the Circular Guo Shui Han [2009] No.777, where the enterprise seeks loans from its employees or other individuals, the interest expenses incurred to the extent that they do not exceed the amounts calculated by reference to the interest rates applicable to loans of the same period and category made by financial institutions are deductible for CIT purposes if

certain conditions are met. In other words, “the interest rate for the same period and category of loan” also serves as benchmarking for determining the reasonableness of the interest paid by enterprise to individuals for CIT purposes. As such, we understand the rules stipulated in Announcement 34 may also apply to loans made by individuals to enterprise.

#### **8. What if the lenders are non-resident enterprises?**

We understand the rules in Announcement 34 may apply if the lenders are non-resident enterprises.

“Excessive interest” under the thin capitalisation rules that is paid to a non-resident lender would not only be disallowed in the hands of the domestic borrower, but also treated as dividends distribution and subject to Withholding Tax accordingly. Such deemed dividends do not seem to be addressed by Announcement 34 in the case of disallowance due to excess rate.

#### **9. What are the Business Tax implications of the rules on inter-company loans?**

Announcement 34 only sets out guidelines on the interest rate for an inter-company loan from CIT perspective and does not apply to BT treatment of inter-company loan directly. However, Article 7 of the Business Tax Provisional Regulations provide that where the price for the provision of taxable services, transfer of intangible assets or sale of immovable properties rendered by a taxpayer is obviously and unjustifiably low, the tax authorities in charge shall impute the amount of turnover. Tax authorities in charge of CIT are concerned with excessive deduction while those in charge of BT are concerned with understated revenue. In any event, the tax authorities in charge of BT may impute loan interest using similar principles in Announcement 34.

#### **KPMG observations**

There has been no uniform guidance on the scope of “interest rate for the same period and category of loan” before the release of Announcement 34. There have been variations among the local tax authorities in interpreting the relevant rules, which has increased compliance risk of taxpayers. In addition, China’s current tight monetary policy has made it difficult for enterprises, especially the small and medium-sized enterprises, to seek loans from financial institutions, which in turn, causes some corporations to resort to private lending. The release of Announcement 34 has provided clear guidance with regard to the CIT treatment of inter-company lending and helps to eliminate the dispute between the tax authorities and taxpayers. Taxpayers shall carry out more thorough review of their inter-company loans, prepare and submit the Statement on Interest Rate to the tax authorities within the specified time frame to ensure that all the qualified interest expenses can be deducted for CIT purposes.

In practice, financial institutions such as commercial banks usually decide the interest rate applicable to a specific loan based on the benchmark interest rate of RMB loan released by the People’s Bank of China, taking into account factors such as credit worthiness, asset scale, type of guarantee and future trend of development of the borrower. In other words, the interest rates made by financial institutions may vary greatly from borrower to borrower. As mentioned above, whether the taxpayer can provide the statement on the interest rate for the same period and category of loan made by certain financial institution in the same province as reference acts as one of the decisive factors in determining the deductibility of its interest expenses for CIT purposes. Taxpayers shall be mindful of this new requirement.

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