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China alert

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MoF and SAT clarify Corporate Income Tax deduction rules for advertising and promotional expenses

Regulations discussed in this issue:

Notice on Corporate Income Tax Deduction for advertising and promotional expenses, Cai Shui [2012] No.48, issued by the Ministry of Finance and the State Administration of Taxation on 30 May 2012, effective on 1 January 2011.

Background

The Ministry of Finance (MoF) and the State Administration of Taxation (SAT) jointly issued Cai Shui [2012] No. 48 (Circular 48) on 30 May 2012, setting out the Corporate Income Tax (CIT) deduction rules for advertising and promotional expenses (A&P expenses) in certain industries or under certain business arrangements. Circular 48 provides that the deduction rules for A&P expenses contained in Cai Shui [2009] No.72 (Circular 72) regarding selected industries will basically continue to apply; however, the deduction rules for allocated A&P expenses under certain arrangements have been adjusted. The CIT deduction rules for A&P expenses stipulated in Circular 72 came to an end on 31 December 2010. Circular 48 picks up where Circular 72 left off, taking effect from 1 January 2011 to 31 December 2015.

The key points of Circular 48 and our discussions are summarised below:

1. Raising the upper limit for A&P expenses deduction to 30 percent of annual sales (business) revenue for certain industries

The implementation rules for the new CIT law, effective from 1 January 2008, provide that, unless prescribed otherwise by the departments of the State Council in charge of finance and taxation, qualified A&P expenses incurred by an enterprise shall be deductible up to 15 percent of the sales (business) revenue for the year; any excess amount can be carried forward and deducted in succeeding tax years.

Given that enterprises in some industries may incur significant A&P expenses every year, resulting in excessive A&P expenses that may actually not be deductible in succeeding tax years, the MoF and the SAT jointly issued Circular 72 on 31 July 2009, raising the upper limit for A&P expense deduction to 30 percent of sales (business) revenue for certain industries, including manufacturers of cosmetics, pharmaceuticals and beverages (excluding alcohol). Circular 72 expired on 31 December 2010.

Under Circular 48, A&P expenses incurred by manufacturers and distributors of cosmetics, manufacturers of pharmaceuticals and manufacturers of beverages (excluding alcohol) can be deducted for CIT purposes to the extent not exceeding 30 percent of the sales (business) revenue for the year; any excess amount can be carried forward and deducted in succeeding tax years. Therefore, Circular 48 upholds the aforementioned principles from Circular 72, and expands the scope of the enterprises that can enjoy the higher deduction limit, i.e., distributors of cosmetics can also enjoy the higher deduction limit of 30 percent on A&P expenses.

2. Calculation basis for the upper limit for A&P expense deduction

According to the implementation rules for the new CIT law and the relevant regulations, the base number for computing the upper limit for A&P expense deduction for CIT purposes is the sales (business) revenue of the year, including revenue from the enterprise's principal activities, revenue from other operations, and revenue deemed to arise in accordance with relevant tax regulations. An enterprise's non-operating income is not part of the base number.

3. Deduction of allocated A&P expenses for CIT purposes

Circular 48 also contains a provision related to the deduction of A&P expenses for enterprises that have entered into cost sharing arrangements (CSA) with their related parties. Suppose that Company A and Company B are related parties and have executed a CSA covering A&P expenses. Company A incurs certain A&P expenses during a tax year. According to the CSA, part of such A&P expenses will be allocated to Company B. Under Circular 48, it is possible for Company B to deduct the allocated A&P expense for CIT purposes on its tax return.

There are two notable points regarding A&P expenses deduction:

- The sum of Company A's A&P expenses to be deducted on its own return and the A&P expenses to be allocated to Company B and deducted by Company B per the CSA should stay within Company A's A&P deduction cap.

- The A&P expenses allocated from Company A to Company B are not counted by Company B when Company B assesses whether its A&P expenses exceed its deduction cap for the year.

There are somewhat similar provisions for the deduction of allocated A&P expenses for CIT purposes in Circular 72; however, these were limited to certain franchise arrangements in the beverage industry. In Circular 48, the allocation of A&P expenses applies to the CSA scenario.

It should be noted that there are still significant ambiguities as to how this provision should be applied in practice in connection with a CSA. Enterprises should contact Chinese tax authorities to confirm the detailed calculation mechanism for allocation and deduction purposes.

4. Tobacco advertising expenses and promotional expenses of tobacco enterprises are not deductible for CIT purposes

Circular 48 provides that tobacco advertising expenses as well as promotional expenses of tobacco enterprises are not deductible in calculating taxable income for CIT purposes. This represents a continuation of the tax treatment accorded to tobacco enterprises in Circular 72.

In reality, this CIT deduction rule on A&P expenses of tobacco enterprises is in line with other regulations in China, which impose strict restrictions on tobacco advertisement. For example, tobacco advertisement in broadcasts, movies, television, newspapers and periodicals is forbidden; tobacco advertisement in public places such as waiting rooms, theatres, cinemas, meeting halls, or sports venues is also prohibited.

However, there is still uncertainty regarding the scope of 'tobacco advertising expenses and promotional expenses'. If a tobacco enterprise is also engaged in non-tobacco business, Circular 48 does not say whether promotional expenses for the non-tobacco business are deductible. Thus, tobacco enterprises with diversified operations should keep a close eye on the practices of local tax authorities.

5. Deferred tax computations

For most enterprises, A&P expenses exceeding the deduction limit can be carried forward and deducted in succeeding years when there is sufficient cap. As such, a temporary difference between accounting and tax occurs, and deferred tax assets should be recognised. Enterprises should perform deferred tax computation based on the deduction cap in Circular 48 and assess the proper amount of valuation allowance accordingly.

The accounting and tax difference resulting from non-deductible tobacco advertising expenses and the promotional expenses of tobacco enterprises is a permanent difference. No deferred tax issues are involved.

KPMG observations

Some of the rules in Circular 48 follow the principles laid out in Circular 72, which reflects policy stability and continuity, and the adjustment to the allocated A&P deduction principle signals a new policy development. Enterprises are encouraged to note the following points in practice:

First, Circular 48's implementation is retroactive to 1 January 2011. However, it is likely that enterprises in industries covered by the circular may have deducted their A&P expenses based on an upper limit of 15 percent of their annual revenue, and have completed their annual CIT filing for 2011, prior to the issuance of this circular. If so, retroactive adjustments may be need. For expenses not fully deducted under the aforementioned circumstances, it seems reasonable that enterprises can claim retroactive deductions in accordance with Article 6 in SAT Announcement [2012] No.15 for a tax year in the preceding five-year period. CIT, which was overpaid due to the abovementioned reason, can then be used to offset against the CIT payable for the current year when a retroactive deduction is claimed. If the overpaid CIT exceeds the CIT payable for the current year, the excess amount is allowed to be offset against the CIT payable for succeeding years, or to be refunded.

Second, Circular 48 does not clarify the scope for manufacturers and traders of cosmetics, manufacturers of pharmaceuticals and manufacturers of beverages. It is unclear how to decide whether an enterprise falls within the scope of the aforementioned enterprises when the enterprise operates in multiple business lines and segments. Using the cosmetics industry as an example, if a manufacturer of consumer goods produces not only cosmetics, but also cleaning products and dental ware, whether the enterprise can be recognised as cosmetics manufacturer and under what conditions is unclear. Once the enterprise is recognised, it remains unclear whether expenses will be allocated by segments, and how the A&P expenses of the enterprise will be deducted based on relevant deduction limits. The same problems exist in the other industries mentioned above. Affected enterprises are advised to keep a close eye on further developments in this regard.

Finally, although Circular 48 does not specify that the CSA it refers to is the same concept covered by Guo Shui Fa [2009] No.2 (Circular 2), it would not be surprising if local tax authorities view them as the same. If this happens, enterprises should note that the relevant definitions and requirements in Circular 2 can be referenced by the tax officials. For instance, according to Circular 2, CSA signed by related parties should be reported to the SAT for record; otherwise, the CSA may not be accepted for CIT purposes.

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