

China Tax for the **Auto Industry**

Tax update and planning for auto industry

1. Consumption Tax ("CT") planning ideas need to be revisited taking into consideration of the upcoming CT reform

CT is technically only levied on manufacturers in China when they sell the taxable products (including auto vehicles) to the customers, based on the selling price of the products, which gives rise to the following two common planning opportunities for auto manufacturers in China to optimize their CT cost:

- Some auto manufacturers in China adopt sales models whereby a manufacturing company sells completed auto vehicles to a related party trading company (e.g. national sales company) for its on-sale to distributors to achieve CT efficiency. Under the current tax regime, such models are technically workable (as CT would only be imposed on the manufacturers not the distributors) and compliant with relevant CT regulations; and

- Similar to the above case, another planning for CT purpose is sales made by the head office of auto manufacturers through their sales branches. If a sales branch is independently accounted for with a separate local tax registrations (i.e. the branch is treated as a separate CT payer), there would be chances for the manufacturing head office to treat sales to the sales branch as sales to a separate legal entity from CT perspectives, and pay CT based only on the selling price to the branch.

Some auto manufacturers have been adopting the above business models for years and others are in the process of implementing such business models. There has been, however, a widespread speculation that a CT reform will likely be introduced in 2015, which might affect the tax efficiency of the above CT planning arrangement. We are aware that the following changes are being considered by the authorities in the coming CT reform:-

- The taxing point may be changed from manufacturing to retail sales by the dealers, which would give rise to an increase of taxation basis of CT and accordingly a higher CT burden for the consumption of such products. Given that the auto industry is a regulated industry insofar as the government can control the licensing of the dealers, the auto industry may be a priority for such a change in the taxing point; and
- The applicable CT rate for some products is likely to increase and for some other products is likely to decrease. For auto industry, it is likely that cars with lower cylinder capacity or using new energy may be entitled to a lower CT rate, while, cars with higher cylinder capacity may be entitled to a higher CT rate.

Given the potential CT reform may impact not only the aforementioned CT planning currently adopted by auto OEMs but also the operation performance of various parties along the supply chain of auto vehicles (e.g. dealers, etc.), it is recommended to review the current business model and planning activities and develop efficient CT planning (which would definitely involve both manufacturing companies and dealers) in due course. Given the CT reform potentially shifts the taxing point to the retail sales by the dealers, the possible planning under the upcoming CT reform should focus on changing the promotion schemes currently offered by dealers to the end customers to other arrangements to reduce the end price payable by the consumers (e.g. providing the optional extras and charging the price separately or by the third party directly to the end customers).







2. Tax depreciation of fixed assets with impairments

Auto and auto component companies commonly invest substantially in fixed assets (e.g. manufacturing machineries and equipment). Therefore, claim of depreciation of fixed assets in a tax efficient and compliant way is critical for those companies.

As a result of technology improvement and upgrade of products, it is not uncommon to provide for impairments on the manufacturing facilities (e.g. machineries and equipment). From an accounting perspective, depreciation is calculated based on the value of the equipment net of provision for impairment. However, it has also been our experiences that some local PRC tax authorities would require that depreciation expenses not recognized from accounting aspects cannot be recognized and claimed as a deduction for Corporate Income Tax (“CIT”) purpose either. In other words, those local tax authorities require taxpayers to calculate tax depreciation also based on the value of the equipment net of the impairment provision for CIT purpose, which, would clearly lead to an under-claim of depreciation till the assets are disposed of.

Chinese tax law, however, stipulates that fixed asset depreciation for CIT purposes should be calculated based on the historical tax cost of the assets (regardless of whether an impairment provision has been raised as long as the impairment provision made, if any, has not been deducted for CIT purposes). State Administration of Taxation issued Notice No. 29 in 2014 emphasizing that the fixed asset depreciation for CIT purpose should be calculated based on the historical cost and the impairment provision made for accounting purpose is not deductible for CIT purpose. Accordingly, the practices adopted by some tax authorities as mentioned above appear to lack regulatory ground. With the above in mind, taxpayers are suggested maintain complete and sufficient documentation to substantiate the original cost of fixed assets and no impairment provision being deducted for CIT purposes previously to support and defense the treatment of calculating fixed asset depreciation based on the historical tax cost of the assets.



3. R&D super deduction

In the 2nd Issue of our China Tax for **Auto Industry**, we briefly introduced the R&D Super Deduction incentives and the common issues faced by companies claiming the R&D Super Deduction. While we have seen that many auto manufacturers and auto parts players continue to invest heavily in R&D activities in China and issues commonly arise regarding the R&D Super Deduction application process. We, list below some of these issues and our recommendations to enhance the R&D Super Deduction claims process.

Is your 'manufacturing process' modification eligible for the R&D Super Deduction?

A thorough and comprehensive understanding of what kinds of R&D activities would be eligible for the bonus deduction is crucial to maximizing the benefit and managing R&D compliance risk.

It is very common that some R&D activities which may not fall into the traditional 'pure' concept of R&D may still be eligible for the R&D bonus deduction. In our experience there is a key opportunity for companies in the auto sector to identify 'process' R&D activities which involve the requisite levels of new knowledge and improved technologies to satisfy the R&D regulation in the PRC.

We set out below potentially eligible R&D activities applicable to auto manufacturers and the auto parts industry, which might easily get overlooked by many auto companies:

- Improved quality control detection systems to reduce faulty product/returns and enhance vehicle safety and performance
- Design, construction of new and improved plant and manufacturing facilities in China
- Improved sequential conveyer techniques to increase efficiency and reduce production costs
- Improved lean and streamlined processing operations to reduce cost and optimize efficiency for auto products and assemblies
- Development of production processes to reduce manufacturing/industrial emissions, greenhouse gases and water use
- Development of specifications/designs to accept cost-down/lower cost source raw materials
- Customization and localization of pre-existing casting and machining designs for local Chinese and other markets

Demonstrating new knowledge and an improved product or process

One of the greatest challenges to generating value from the R&D Super Deduction is determining which activities meet the legislative requirements. The key to a successful R&D claim is knowing how to prepare and maintain sufficient documentation to support the authenticity and eligibility of the R&D project, eg.

- Preparing a statement regarding the differences of the new and improved company R&D technology as compared to the current state of the art of the technology in the auto industry
- Highlighting the technical risks and challenges associated with the auto process or product development
- Explaining any novel solutions achieved during the project, including customisation and localisation of processes and products for the PRC market which were technically challenging and involved an investigative approach
- Documenting the activities where possible to detail the nature of any pilot or full scale trials, design solutions, failures and feedback R&D results on a contemporaneous basis.

Allocation of shared cost

It is commonly seen in the auto industry that potentially eligible R&D costs are shared between R&D and manufacturing operations such as staff cost of certain departments, depreciation of certain fixed assets, consumption goods, etc, which need to be allocated between R&D expenses and normal operating expenses in a reasonable way. In this regard, it is important to ensure that there is a direct and reasonable nexus between the manufacturing R&D activities and the allocation of costs to the R&D cost centre. As such, auto companies can improve (1) the identification of 'process' related R&D activities and (2) flag such 'process' R&D expenses in such a way to meet tax authority compliance protocols.

As such, we suggest that sufficient documentation (e.g. working hour allocations, technical reports, test documents, documents for the use of fixed assets/materials and other internal documents) be prepared and maintained to accurately record and/or reasonably reflect relevant shared costs/expenses between R&D and non-R&D activities. Ideally this should be completed on a regular basis to substantiate the efforts involved in completing the relevant process related R&D activities.

Staff cost

We appreciate that some staff extensively involved in R&D activities (such as customer feedback specialists, operations and engineering managers, project leaders etc) might officially belong to other functions (e.g. manufacturing function) rather than the R&D function. To more accurately reflect the R&D nature of such personnel, it is prudent to gather the relevant technical documents and supporting evidence to highlight the allocation of staff costs to the relevant R&D project and R&D cost centre. If such a formal allocation is not feasible, we recommend, as a minimum, that a company maintains a detailed description of the specific activities and job responsibilities related to the relevant R&D project to justify their involvement in R&D activities.

The list of opportunities and challenges mentioned above is certainly not exhaustive, but with effort and appropriate guidance from a seasoned R&D tax practitioner it is possible that these and other matters can be resolved to enhance the benefit from the R&D Super Deduction and still be fully compliant with PRC regulations.



Contact us



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

Northern China



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

Central China



William Zhang
Partner, Tax
National Auto Sector Leader
Tel. +86 (21) 2212 3415
william.zhang@kpmg.com

Southern China



Lilly Li
Partner, Tax
Tel. +86 (20) 3813 8999
lilly.li@kpmg.com

Hong Kong



Daniel Hui
Partner, Tax
Tel. +852 2685 7815
daniel.hui@kpmg.com

Transfer Pricing



Cheng Chi
Partner in Charge, Transfer
Pricing
China and Hong Kong SAR
Tel. +86 (21) 2212 3433
cheng.chi@kpmg.com

Indirect Tax



Lachlan Wolfers
Partner, Tax
Leader, Centre of Excellence,
Indirect Taxes
Tel. +852 2685 7791
lachlan.wolfers@kpmg.com

Trade & Customs



Eric Zhou
Partner, Tax
Beijing
Tel. +86 (10) 8508 7610
ec.zhou@kpmg.com

R&D



Bin Yang
Director, Tax
Leader, China R&D Tax Practice
Tel. +86 (20) 3813 8605
bin.yang@kpmg.com

Automotive Sector Leader



Danny Le
Partner,
Head of Automotive,
China and Asia Pacific
Tel. +86 (10) 8508 7091
danny.le@kpmg.com

Automotive Sector Leader



Michael Jiang
Partner, Corporate
Finance
Head of Automotive,
China
Tel. +86 (10) 8508 7077
michael.jiang@kpmg.com

Audit



Norbert Meyring
Partner, Audit
Tel. +86 (21) 2212 2707
robert.meyring@kpmg.com

Transactions & Restructuring



Linda Lin
Partner, Transactions &
Restructuring
Tel. +86 (21) 2212 3525
linda.lin@kpmg.com

Consulting



Leah Jin
Partner, Consulting
Tel. +86 (21) 2212 3633
leah.jin@kpmg.com

kpmg.com/cn

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