

## China Tax Law Commentary

### 中国税务评论



#### In this update

- Summary of major tax law changes in the past two months that will affect year-end planning

Happy Holidays! As the year comes to end, it is time to review some recent tax law changes and plan ahead for the New Year. In the past two months, the Chinese authorities have issued numerous major tax law changes that either took effect immediately or become effective on January 1, 2009. These tax law changes will affect virtually every MNC doing business in China. Below is a summary of selected tax law changes and related implications for US MNCs.

#### Upcoming Webcasts

**China and the Global Financial Crisis** (11:00 AM EST, Jan 15, 2009, Clarence Kwan, Chris Lu, Vice-Mayor Ren) [Click here](#)

**China Tax & Regulatory Update** (11:00 AM EST, Feb 12, 2009, Lili Zheng, Sarah Chin, Jeff Xu) [Click here](#)

#### Selected Tax Law Changes

##### 1. Value Added Tax ("VAT")

- Effective January 1, 2009, China's VAT system will shift from the existing production-based VAT system to a system based instead on consumption. The provisional rules were issued on November 14, 2008. The major changes include: (1) allowance for recovery of VAT incurred on fixed assets; (2) reduction of the VAT rate for small-scale taxpayers to a uniform 3% instead of the current 4%-6% rates; (3) removal of the VAT exemption for equipment imported for the processing and assembly trades and other sectors.
- Due to the international financial crisis' effect on China's exports, the central government announced another increase to the export VAT refund rates on November 12, 2008 in Caishui [2008] 144. This is the third increase that the Chinese government has announced since August 2008. This latest round of export VAT refund rate increase applies to 3,770 products, which account for 27.9% of the total tariff headings.

- c) The above are welcome changes for U.S. MNCs, as the VAT cost will be reduced for future fixed asset investments in China and export costs are also reduced for those companies that manufacture or source their products in China for export to the U.S. or elsewhere.

## 2. Customs

- a) The China-Singapore Free Trade Agreement ("CSFTA") was signed on October 23, 2008, and becomes effective on January 1, 2009. Under the terms of the CSFTA, all goods of Singaporean origin (with some exceptions) should enjoy tariff-free access to China by 2010; and more than 85% of the Singapore exports to China, which satisfy the origin criteria, should not be subject to customs duties once the CSFTA becomes effective.
- b) From the perspective of Singapore exporters, companies in the petrochemicals, processed foods, electronics and electrical products sectors will be the main beneficiaries of the new bilateral CSFTA.
- c) Singapore is increasingly being used by many US MNCs as a location for manufacturing or value-added processes. With proper planning, these products may be able to meet the origin requirement under the CSFTA, which could reduce the overall costs for selling into China.

## 3. Business Tax ("BT")

- a) The Ministry of Finance and State Administration of Taxation have jointly released revised Provisional BT Implementation Rules in Order 52 ("New Rules") on December 15, 2008. The New Rules take effect on January 1, 2009.
- b) One of the major changes that would affect foreign services firms (e.g., law, architecture, design and other professional services firms) is that under the new BT regime, offshore services will also be subject to BT in China if the service recipient is a Chinese entity or individual. In addition, the New Rules also stipulate that if the service provider is a PRC entity, 100% of the revenue will be subject to BT no matter where the service is performed.
- c) This is different from the existing rules where only services performed in China are subject to business tax. Obviously this change will have significant negative impact on China-based offices of foreign professional service firms that provide services outside China for Chinese entities. It is still unclear whether services provided outside China to a Chinese entity before 2009, but where payment is made in 2009, will also be subject to these New Rules. In order to avoid the application of the New Rules to payments received in 2009 for services rendered outside PRC during 2008, it is advisable to settle these payments as soon as possible.
- d) There are also a number of BT exemptions provided to certain qualified enterprises, including schools and educational entities that can provide certifications and are approved by relevant authorities.

- e) It is interesting to note that on August 21, 2008, various Shanghai authorities jointly issued Circular 38 on "Policies to promote a changing economic development model and adjust the structure of industry." This Circular aims to accelerate the development of the services industry in the Shanghai area. Circular 38 includes financial subsidies and tax rate reductions for companies in the advanced manufacturing, modern service industries, as well as headquarters companies. One of the key benefits is that BT will be collected on a "revenue less related expenses basis" for companies in the professional services industry (including agency services in accounting, taxation, asset valuation, law, etc.), modern logistics industry, and the exhibition industry, if they meet certain criteria. On its surface, this local rule may contradict the New Rules on BT, which were issued just a few days ago. It is not clear how this may impact the actual application of Circular 38 in Shanghai.

#### **4. Transfer Pricing**

- a) The Chinese State Administration of Taxation released nine related party transaction disclosure forms on December 16, 2008 (Guoshuifa [2008] No. 114) to replace Forms A-13/B-13 previously required as part of China's annual income tax return filing requirement for foreign-invested enterprises. These forms are due on May 31, 2009.
- b) As part of Form 2, companies are asked to disclose whether they would be exempted from preparation of contemporaneous TP documentations, whether they have prepared contemporaneous TP documentation if not exempted, and whether they have reached Cost Sharing Agreements. The release of these new forms indicates that the release of detailed contemporaneous documentation rules is imminent!

#### **5. Thin Cap Rules**

For those of you who have read the last discussion on the Thin Capitalization rules, we were able to confirm with local tax authorities that our interpretation 2 was correct. This means that as long as the financing is at arm's length, the entire amount of interest expense will be deductible regardless of the debt-to-equity ratio. If the financing is not at arm's length, the amount of allowable interest will be governed by the relevant debt-to-equity ratio.

#### **What Should U.S. MNCs Do?**

Suffice to say that the last two months have been busy for various Chinese authorities. With the most significant changes to the overall indirect tax system since 1994, a number of other measures to stimulate the economy, new transfer pricing documentations rules, and the new Enterprise Income Tax Law just put in place at the beginning of the year, taxpayers will have to get up to speed quickly on these new rules and determine not only how they may be impacted, but also the best way to navigate the new tax environment. These changes can be overwhelming, even for specialized

professionals. Please mark your calendar to join us for an [informative webcast on February 12, 2009](#), where China experts will break down these developments in laymen terms for our audience.

For a more detailed technical analysis on each of the following topics, please refer to tax alerts attached:

1. VAT and BT reform - [NTC Tax Analysis Issue P42/2008](#)
2. VAT refund rate increases - [NTC Tax Analysis Issue P35/2008](#)
3. CSFTA - [NTC Tax Analysis Issue P34/2008](#)
4. Related party TP reporting - [NTC Tax Analysis Issue P41/2008](#)

We will continue to monitor the development in the Chinese tax laws and bring changes to your attention in a timely manner. Please feel free to contact our regional team members listed below should you have any questions.

[Wish you a joyous holiday season and prosperous New Year! We will connect with you again in the year of Ox!](#)



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