

taxtalk newsletter

Grant Thornton 
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“National treatment” for investors in China...

China has gradually opened a variety of trades and industries to foreign investors pursuant to its WTO commitments. To provide “national treatment” for all investors, China plans to unify the enterprise income tax (EIT) for both domestic and foreign-invested enterprises (FIEs), lowering the rate from 33% to within a range of 25% to 28%. The existing practices allow FIEs more favourable tax treatments and lower effective tax rates than their domestic counterparts. Future tax incentives are likely to be granted by industry, instead of according to enterprise status. However, earlier in the year, it was reported that a group of multi-national corporations (MNCs) have jointly petitioned for an extension to the tax incentives that they currently enjoy. The latest speculation is that the unified EIT law may become effective by 2007. The general view of the foreign business community is for China to promulgate the unified EIT law as soon as possible, as the uncertainty could affect plans for investing in China.

The liberation of the Chinese market offers tremendous business opportunities for MNCs, and results in an increase in cross-border as well as intra-China business transactions involving two or more related parties. China has now developed a solid foundation for

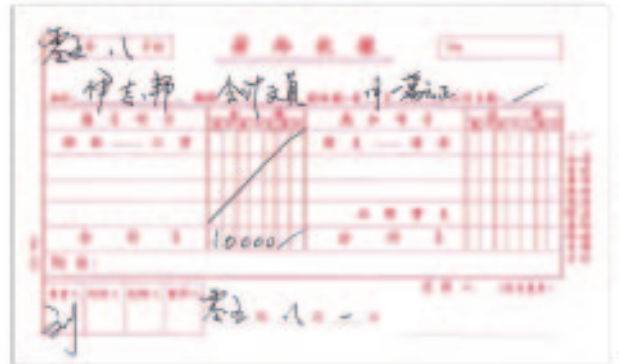
transfer pricing regulation. The Chinese tax authorities have also stepped up transfer pricing enforcement at both the local and state levels, and have re-emphasised joint nationwide transfer pricing audits on high-risk taxpayers, including FIEs as well as domestic enterprises. Proactive foreign investors may consider reaching advance pricing agreements with the Chinese tax authorities to avoid unexpected tax consequences.

In recent years, China has encouraged more Chinese enterprises to “go out” and invest abroad. This has expanded China’s taxation horizon from being predominately domestically oriented to becoming more internationally focused. To protect the interests of Chinese investors abroad, effective 1 July 2005, if a Chinese investor considers that it has not been properly treated by a treaty country where the overseas investment is located, the Chinese investor may apply to the relevant Chinese tax authorities to initiate a consultation process under the double tax agreement with that country. As an FIE is also a Chinese legal entity, by analogy it may also initiate the consultation process for its investments abroad.



Michael To, Senior Tax Manager (left) and **Daisy Ip**, Senior Tax Manager (right) of Grant Thornton

New Individual Income Tax (IIT) regulations on stock options



On 28 March 2005, the Ministry of Finance and the State Administration of Taxation jointly issued Cai Shui (2005) No. 35 (the Notice), clarifying IIT issues relating to stock option gain. The Notice came into effect on 1 July 2005.

Definition of stock option

The Notice gives a definition of stock option, grant date, exercise date, etc., which are generally in accordance with international practice.

Definition of the nature of income related to stock option

The Notice has also clarified the following:

- Generally, a stock option is not counted as taxable income at the time when it is granted to an employee.
- When the option is exercised, the difference between the exercise price and the market price (i.e. the option gain) is regarded as employment income for the employee.
- Capital gain relating to the subsequent sale of the stock obtained from the exercise of the stock option is regarded as "income from asset transfer" and will be taxed according to the relevant tax regulations.

Calculating the IIT liability related to stock option

According to the Notice, IIT on stock option gain will be calculated as follows:

- The stock option gain can be calculated separately from the employee's normal monthly income, instead of adding the gain to the monthly income as stipulated in Guoshuifa (1998) No. 9.
- Only China-sourced stock option gain will be subject to IIT. Stock option gain can be apportioned with reference to the number of months the employee was working inside and outside China. This is in accordance with Guoshuihan (2000) No. 190.
- The Notice introduced a new formula for calculating IIT on stock option gain:

$$\text{IIT on stock option gain} = [(\text{taxable stock option gain} / \text{applicable months}) \times \text{applicable tax rate} - \text{quick deduction factor}] \times \text{applicable months}$$
 "Applicable months" is defined as the number of months the employee is required to work to exercise the stock option. The cap for the "applicable months" is 12 months.

The Notice has clarified some long-outstanding issues and has introduced a calculation method which will generally reduce the IIT liability for most taxpayers. However, some uncertainties remain:

- Apparently the Notice only applies to stock options. It does not clarify whether the new regulation applies to other forms of stock related incentives, like stock awards or employees stock purchase plan.

We anticipate that the IIT treatment for these stock related incentives will vary from location to location. For example, Shenzhen Local Tax Bureau has issued Shendishuifa (2005) No. 301 which specifically states that the Notice only applies to stock options. For other forms of stock related incentives, the IIT should be calculated according to Guoshuifa (1998) No.9.

- The Notice does not clearly define the "applicable months" for use in the new formula. Does it refer to the stock option's vesting period, the period from the commencement of the PRC assignment to the date of exercise, or any other time period?

Foreign Invested Commercial Enterprises (FICEs)



The Chinese Ministry of Commerce (MOFCOM) issued Decree No. 8 (the Decree) on 16 April 2004. This Decree lifts the restrictions on foreign investment in the distribution sector including wholesale, retail, etc.

According to the Decree:

1. The requirement to form a joint venture with a local Chinese partner to participate in distribution activities has been removed. Foreign investors are allowed to set up wholly foreign owned FICEs.
2. Geographical restrictions have also been removed. There will be no geographical restrictions on setting up foreign invested wholesale and retail companies in China.
3. A foreign investor forming a FICE should have a good reputation, and should not have past records of violations of China's laws and regulations.
4. The minimum registered capital of a FICE engaging in wholesale and retail activities is RMB500,000 and RMB300,000 respectively. Although the entry requirements have been reduced, FICEs are still required to observe the standard debt/equity ratio to avoid the investment relying overly on debts.

5. Foreign invested enterprises (FIEs) other than commercial enterprises (e.g. manufacturing companies) may apply to expand their business scope and engage in wholesale and retail activities pursuant to the provisions of the Decree.

In practice, the minimum capital amount is for reference only. The amount of capital will be decided by the level of activities proposed.

Foreign Enterprise Income Tax (FEIT) for FICEs

FICEs are not usually entitled to the preferential tax treatments that are usually available to FIEs engaged in production activities. Profits earned by FICEs will be subject to FEIT at the normal rate of 33%. This tax rate may be reduced if a FICE is based in an area where a reduced tax rate is applicable. For example, a tax rate of 15% applies in the Special Economic Zones.

On 2 April 2005, MOFCOM issued a notice (the Notice) detailing the application procedure for the expansion of business scope for production-oriented enterprises.

The Notice indicates that after the expansion of business scope, a production-oriented enterprise will be regarded as a non-production-oriented enterprise if the distribution revenue exceeds 30% of the enterprise's total revenue. This potentially may affect the tax incentives available to FIEs engaged in production activities.

Value Added Tax (VAT) for FICEs

A newly set up FICE will be registered either as a general taxpayer or a small-scale taxpayer.

A FICE which cannot satisfy the relevant requirements stipulated in the existing VAT rules will be regarded as a small-scale taxpayer and will be subject to a lower tax rate of 4%, but is not entitled to offset any input VAT against output VAT.

On the contrary, a general taxpayer is allowed to set off the input VAT arising on purchases against the output VAT on sales. The tax rate of 17% applies to general taxpayers.

Transfer pricing developments in China



In the last decade, China's transfer pricing regime has undergone rapid development. Before 1998, the Chinese approach to transfer pricing was relatively primitive and was incorporated into "The Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises". Since its admission to the World Trade Organisation, China has been under pressure to bring its tax system in line with international standards. China has now developed a solid foundation for transfer pricing regulation.

The most up-to-date legislation with regard to transfer pricing is Guoshuifa [2004] No. 143. The new legislation has standardised transfer pricing administration procedures and clarified certain unclear areas contained in an earlier piece of legislation: Guoshuifa [1998] No. 59.

The salient issues in Guoshuifa [2004] No. 143 are summarised below:

- Taxpayers effectively have 90 days to provide information requested by the tax authorities if written consent from the relevant tax authorities is given. Penalties

can be imposed for late submission of information or submission of false information.

- If the taxpayer is unable to provide the required information, provides false information or is unwilling to provide information, the tax authorities can adjust the revenue or profits of the taxpayer based on one of the following methods:
 - a) Reference to taxpayers with a similar scale of operation and income level
 - b) Determination of the level of profit based on a reasonable level of taxpayer's income or costs
 - c) Estimation of the raw materials, fuels and power consumed
 - d) Other reasonable methods.
- Tax authorities can make transfer pricing adjustments retrospectively for a period of 3 to 10 years. The 10-year adjustment may apply under the following circumstances:
 - a) where the cumulative amount of related-party transactions exceeds RMB100,000
 - b) where the estimated retrospective adjustments exceed RMB500,000
 - c) where a taxpayer has previously had transactions with related parties in tax-haven countries
 - d) where a taxpayer has failed to comply with the related-party disclosure requirements in its annual tax return in previous years, or if, upon further audit investigation, a taxpayer is found to have provided incorrect information on its pricing and costs regarding its related party transactions.
- Overpayment to related parties after transfer pricing adjustments could be deemed as dividend payment and be subject to withholding income tax (with no exemptions). Where there is a transfer pricing adjustment to disallow part of the interest or royalty payments, withholding tax already paid is not refundable.

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