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Interest Earned from Securities Exempted from Individual Income Tax

On 26 October 2008, the State Administration for Taxation announced an exemption from individual income tax liability for interest income generated on or after 9 October 2008 from funds settled in individual securities transactions (*Caishui* (2008) No.140).

Previously, such interest would have been a taxable item (*Guoshuihan* (1998) 546). This is further move to encourage investment in securities in a market that has been ailing since October 2007. In mid-April last year, the government reduced the stamp duty on shares trades from 0.3 percent to 0.1 percent.

Whilst this recent change is only limited to interest income, it should still provide an extra incentive for investors.

Quick Bites: When is an Individual Liable for Income Tax in China?

There are four general rules:

1. Individuals domiciled in China are taxable on worldwide income;
2. Expats who have lived in China for more than five consecutive years are taxable on worldwide income;
3. Expats who have lived in China for one year or more are taxable on China sourced income plus any income paid to them by individual or enterprise located in China.
4. Expats who have lived in China for more than ninety days (or 183 days when a tax treaty applies) are taxable on China sourced income.
5. Expats resident for less than ninety (or 183) days are only taxed on income paid to them by an establishment in China.

VAT Reform

On 1 January 2008, radical changes to China's value added tax regime came into operation, pursuant to the new Provisional Regulations of the People's Republic of China on Value Added Tax.

The most important change has been national expansion of the pilot scheme providing full VAT credit on fixed asset purchases, effectively shifting China's VAT system from a production-based regime to one based on consumption.

Previously, no input tax credit was allowed for purchases of fixed assets, but rather the VAT would form part of the capital cost of that asset. As a result, the new regime provides for greater recovery of VAT than previously was allowed.

The primary motivation for the change was the desire to encourage investment activities as economic growth in China continues to decline. It is hoped that lowering the costs of capital acquisitions will reduce the cost of investing.

Some of the other more important changes in the new regulations include:

1. Removal of the VAT exemption for imported equipment, as previously provided for under *Guofa* (1997) 37.
2. Increase of the VAT rate for mineral products back to 17 percent, from the previous reduced rate of 13 percent.
3. Removal of foreign-funded companies' eligibility for tax rebates on domestic equipment purchases, putting them on an equal footing with domestic companies.

Property Market Stimulus: Business Tax Exemption Expanded

In an attempt to stimulate the property market, the State Council recently announced a change to the operation of business tax to residential property. From 1 June 2006, the income derived by an individual from the sale of a residential property which has been held for five years or more has been exempt from business tax (see *Caishuizi* (2006) 75). However, the State Council has announced stimulus measures, which include reducing the qualifying period for the business tax exemption to two years (*Caishui* (2008) No.174).

This is a significant reduction in the time required to hold the property before the tax exemption applies, and should lead to increased investment. However it should be noted that this concession is only set to last until 31 December 2009, and only time will tell as to whether the State Council will extend it or make it permanent. More generally, the State Council has expressly indicated its support for the property industry (see *Guobanfa* (2008) No. 131).

These measures come on the back of a slowdown in the Chinese property market, resulting from a combination of post-Olympic overcapacity and the global financial crisis.

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Under the China's Enterprise Income Tax Law the question turns on whether an enterprise is a "resident enterprise" or a "non-resident enterprise". A "place of effective management" test is used to determine whether an enterprise is resident or non-resident. Resident enterprises are those enterprises which are established inside China or whose 'actual office of management is inside China.' An establishment will be considered the "actual office of management" if it exercises substantive and overall management and control over the production and business operations, personnel, financial functions and properties, etc of an enterprise. It has been suggested that this test will require more than 'merely holding board of directors meeting in China', yet it does not require an enterprise to have its head office within China. Resident enterprises are taxed on their worldwide income, generally at a rate of 25 per cent, subject to the phase-out period noted above.

A non-resident enterprise refers to an enterprise established under the law of a foreign country whose place of effective management is not within China but which has offices or establishments inside China, or has income sourced in China. The Regulations on the Implementation of the Enterprise Income Tax Law of the People's Republic of China (the "RIEITL") state that "offices or establishments inside China" refers to offices and establishments that "conduct production activities and business operations" in China, including:

1. Management institutions, operational institutions, and offices;
2. Factories, farms and place for exploitation of natural resources;
3. Establishments for the provision of labour services;
4. Establishments for engineering operations with respect to construction, installation, assembly, repair, surveying, etc.; and
5. Other institutions and establishments where production activities and operations are carried out.

An office or establishment shall also be created within China where a non-resident enterprise engages an agent to 'carry out production activities or business operations within the territory of China, including the entrustment of any entity or individual to sign contracts on its behalf to handle the warehousing or delivery of goods, etc.'

A non-resident enterprise is liable to taxation in China on any income which is effectively sourced from China. In the case of a non-resident enterprise that has offices or an establishment within China this includes both income derived from inside China and income derived outside of China 'but which has a real connection with' its offices or establishments inside China. The concept of a "real connection" with offices or establishments inside China is defined in Article 8 of the RIEITL to mean where the office or establishment within the territory of China 'acquires equity or credit, or owns, manages or controls its property.' The tax rate for non-resident enterprises that do have an office or establishment in China, with respect to income connected to that office or establishment, is 25 per cent.

Non-resident enterprises that do not have an office or establishment inside China, or a non-resident enterprises whose incomes have no actual connection to their offices or establishments inside China, are subject to taxation on any income derived from China ("withholding tax"). Dividends, royalties, interest and rental income are the main types of China source income that most likely would not have a connection with an office or establishment, and accordingly would be subject to withholding tax. The withholding tax rate is 20 per cent under the EITL. However, in accordance with Article 27(5) of the EITL, the RIEITL reduces the withholding tax rate to 10 per cent.

Page 2 of each edition of *China Tax Insights* is dedicated to a briefing on a particular aspect of Chinese tax law, with a focus on issues affecting international transactions.

Anti-Avoidance

Article 47 of the EITL provides Chinese tax authorities with the power to make adjustments 'through a reasonable method' where an enterprise enters into an arrangement 'not for any reasonable business purpose'.

The RIEITL clarifies the meaning of 'not for any reasonable business purpose', stating that it refers to an arrangement where the 'main purpose is to reduce, exempt or defer the payment of taxes'. The tax authorities have a ten year statute of limitations in which to make an adjustment for non-arm's length transactions or for any arrangement not deemed to have a reasonable business purpose.

Lehman, Lee & Xu's corporate and international taxation team, in association with Lehman Tax & Accounting, offers clients unrivalled and comprehensive services relating to both Chinese and international taxation matters, and provides a high standard of technical expertise with a practical and commercial approach.

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