

Tax Implications for pre operating expenses

Q: We are a property company from Indonesia. We just finalized the MOU for joint venture with partner in Wuhan. In this pre-operating stage, we have come into some consultancy contracts; some with MNCs based in China (service rendered in China), some with Indonesian companies which don't have establishment in China (service rendered in Indonesia), some with local companies. Since, the JV company haven't yet established and yet derived any income from China. We're still accumulating this consultancy expenses as part of pre-operating cost and all payments paid by our account in Indonesia. Is there any tax exposure on this matter (some payments already made)?

A: [1] There are several PRC legal rules relating to your question: accounting, income tax, and capital transfer. The PRC accounting rules do not recognize the expenses incurred before the incorporation date as pre-operating expenses. This amount should be borne by the investor or shareholder. The expenses incurred between the incorporation date (the JV comes into existence) and the day the production or business commences is treated as pre-operating expenses. The amount of pre-operating expenses should be charged to income statement on the day the JV commences business operation (or pilot run).

[2] Under the PRC income tax rules, the amount of pre-operating expenses can be deducted from income over a period of 5 years.

[3] The amount of expenses cannot be treated as capital contribution. The JV should wait until it has completed the incorporation, open a capital account, import the capital and hire a local CPA to complete the capital examination. Otherwise any expenses incurred before the capital importation cannot be regarded as capital contribution by the Indonesian Company.

[4] In general, the Indonesian Company will not be in a position to claim reimbursements from the JV for the expenses incurred. The current account balances between JV in China and the Company in Indonesia will not agree with each other.