Taxation on non-resident enterprises (Part 2)

1. PRC source income

Non-resident companies that do not have a permanent establishment in China earn PRC source-income in the form of dividend, interest, royalty, rental income from immovable properties and chattels, service income, and the gain from the disposal of properties in China.

2. Basis of tax computation

In general, dividend, interest income, rental income and royalty will be taxed on a gross basis, meaning that it is taxed without deduction from the gross sum received. The gain on the disposal of properties will be taxed on a net income basis under which the costs and expenses are deductible from the gross income. The income from the provision of services can be taxed on a gross basis or on a net basis. Where the information for the gross service income and expenses cannot be determined from the taxpayer's books of accounts, the tax authority can impose tax on the taxpayer with reference to the gross income. Where the information is available, the income can be taxed on a net basis.

3. Taxation on dividend

Resident companies of non-PRC tax treaty country are subject to tax on dividend income at 20%, as reduced to 10% under the detailed implementation regulations. [1] Resident company of PRC treaty countries are subject to tax at 10%, except that Hong Kong and Singapore Companies will be taxed at 5% subject to the legal ownership in the foreign investment enterprise being no less than 25%.

4. Withholding tax rate

The applicable tax rates for Hong Kong holding companies to receive various payments from a foreign investment enterprise (FIE) in Mainland China will be as follows:

	Nature of payment	Income Tax	Business Tax
1	Dividend	5% / 10%	N/A
2	Interest	7%	5%
3	Royalty	7%	5%
4	Gain from disposal of properties	10%	5%

The applicable tax rates for Singapore holding companies to receive various payments from a foreign investment enterprise (FIE) in Mainland China will be as follows:

	Nature of payment	Income Tax	Business Tax
1	Dividend	5% / 10% [2]	N/A
2	Interest	7% / 10%	5%
3	Royalty	10%	5%
4	Gain from disposal of properties	10%	5%

[1] See Article 91 of the detailed implementation regulations of the PRC Corporate Income Tax Law.
[2] Where the Hong Kong Company owns less than 25% in the capital of the WFOE, the tax rate will be 10%.

A comparison of PRC withholding income tax rates between Hong Kong Company and Singapore Company where the following payments are received from an FIE in China:

	Nature of payment	China-HK DTA	China-Singapore DTA
1	Dividend	5% / 10%	5% / 10%
2	Interest	7%	7% /10%
3	Royalty	7%	10%
4	Gain from disposal of properties	10%	10%

5. Tax rules on interest income

5.1 Income tax

Income tax is imposed at 10% on the gross amount of interest paid by a resident company to a non-PRC resident company. [3] The 10% withholding income tax rate is fixed at the same level of tax rate as that provided in most of the tax treaties China has entered into with its trading partners. However, there are three exceptions. Where the recipient of interest is a resident of Hong Kong or Singapore, the income tax rate is reduced to 7%.

As per double tax agreement between the PRC Government and Singapore Government effective on 1st January 2008, interests paid on loans from non-financial institutions will be taxed at 10%. Where the recipients are the government bodies or government owned institutions of either treaty country, the interest is exempted from income tax. The China-Hong Kong double tax arrangement has the same provision for the tax exemption of interest income.

The interest paid by the PRC resident company to a non-PRC resident will be exempted from income tax if the recipient is a government body or other government owned institutions mutually agreed under the DTA.

5.2 Business tax

Note that interest income was exempted from the 5% business tax between 1st January 1997 and 30th April 2006. The business tax exemption applied to the payment of interest to all foreign companies but it was subsequently repealed as from 1st May 2006. [4]

	Business tax on interest income (5%)	Relevant period
1	Taxable	1994-01-01 to 1996-12-31
2	Exempted under Guo Shui Fa (1997) 035	1997-01-01 to 2006-04-30
3	Taxable	2006-05-01 to present

5.3 Thin capitalization rules

As from 1st January 2008, the PRC corporate income tax law has come into force. Article 46 of the CIT law provides that where a resident company receives from the related parties debt investment and equity investment in a ratio exceeding the prescribed level, the

[3] See State Council Document Guo Fa (2000) 37, as issued on 18th November 2000.
[4] See document Guo Shui Fa (2006) 62 issued by the State Administration of Taxation on 30th April 2006.

interest expenses of the excess portion shall not be deductible in computing the taxable income of the Company. [5]

5.4 Capital structure for property companies

Foreign invested property enterprises are subject to different legal rules in respect of foreign ownership and the capital structure. Foreign investors are not allowed to carry on property investment business in China in the form of wholly foreign owned enterprise with effect from 11th July 2006. Where the foreign investors carry on property investment business in the form of equity joint venture enterprise, the debt and equity of the EJV must comply with a prescribed ratio. The debt to equity ratio cannot be bigger than one where the amount of total investment is USD10 million or more. If the amount of total investment is less than USD10 million, a lower debt to equity ratio shall apply. As a reference point, the PRC ministry of commerce issued a notice for the acquisition by foreign investors of domestically funded companies setting out the ratio between the paid up capital and the amount of total investment for companies that are not doing business in the property sector. The ratio varies with the size of total investment as set out below:

	Paid up capital in USD	Amount of total investment shall not exceed the paid up capital by
1	Amount less than 2,100,000	10/7 (or 1.43 times)
2	Between 2,100,001 to 5,000,000	2 times
3	Between 5,000,001 to 12,000,000	2.5 times
4	Over 12,000,000	3 times

6. Recognition of dividend income

6.1 Accounting rules

Dividend income is recognized where the operating results from joint venture or associated companies are included in the consolidated income statement under the equity method of accounting. In the group accounts, the income is recognized before it is actually received. In the company's accounts, the results of the JV and associates are included in the Company's income statement to the extent of dividend received or receivable. The same accounting treatment shall apply to dividend income received or receivable from subsidiaries. It is because the investment in subsidiaries is stated at cost (less any impairment losses) in the books of the holding company.

6.2 Income tax rules

Tax rules have different provisions from the accounting rules. Dividend income may be exempted from tax or may be taxable. If it is paid from one resident company to another, it is exempted from tax in the hands of the recipient. If it is paid from a resident company to a non-resident company outside China, it is taxable at 10% (or 5% for Hong Kong or Singapore Companies).

[5] The detailed implementation rules for the prescribed level have yet to be announced by the Ministry of Finance and State Administration of Taxation as at 16th July 2008.

Where the dividend income is taxable, it is taxed either on an accrual basis or on an as-earned basis. It is taxed on an accrual basis if it is paid from a resident company including the FIE to a non-resident company. Specifically tax liabilities for dividend income arise on the day when the board of directors passes the resolution to pay a dividend. This will happen where China is a capital importing country. The dividend income receivable by a resident company from a non-resident companies may be taxed on an as-earned basis if it is earned from a CFC set up in a tax haven country or region. This will happen where China is the capital exporting country. The concept of CFC is borrowed from the tax system adopted by members of most OECD countries.

Under the PRC income tax rules, the following requirements must be met for the CFC rules to apply: (i) the company does not distribute its profits or reduces the level of distributed profits not on grounds that are reasonable for operating requirements; (ii) the company is created in a jurisdiction where the effective income tax rate is less than half of the statutory rate (25%) in China, (iii) PRC resident individual or resident enterprise controlled by the resident individuals hold more than 10% of the voting shares of the foreign company, and they collectively hold more than 50% in the shares of the foreign company.

6.3 Tax rules in the home countries or jurisdictions

Where the FIE pays a dividend, the possible tax treatment in the home country will be as follows: (i) no liabilities for tax arise; (ii) tax is exempted; (iii) tax is imposed on receipt basis; and (iv) tax is imposed on as-earned basis.

No liabilities for tax arise if a company set up in British Virgin Inlands or Cayman Inlands receives the dividend. [6] The Hong Kong tax law imposes no tax on the dividend income since it is earned outside Hong Kong. Singapore companies will be subject to tax when the dividend income is received in Singapore. The tax rule on as-earned basis will only apply to companies set up in tax havens. Since China is not one of the tax haven countries, it is unlikely that the dividend income is taxed on as-earned basis in the hands of the recipients.

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[6] Note that BVI and Cayman Inlands Companies will be subject to 10% withholding income tax in China. BVI is not a sovereign state on its own. Both Cayman Inlands and BVI have not signed any tax treaties with China.