

Treatments for inbound and outbound intercompany transactions in China

7 November 2013

AGENDA

- Main tax categories in China
- Inbound intercompany transactions
 1. Products
 2. Services
 3. Technology
 4. Branding
 5. Loan
 6. Guarantee fees
- Outbound intercompany transactions
 7. Contract manufacturing
 8. Contract R&D
 9. Other contract services

MAIN CHINESE TAX CATEGORIES

Custom Duty

- Imposed on the entity and/or individual engaged in producing, consigned processing, or importing taxable consumer goods into China. Import duty rates range from 0% - 100%, with an average duty of 12.47%.

Value Added Tax (VAT)

- Imposed on the entity and/or individual engaged in selling goods, providing processing, repair or replacement services or importing goods, or providing pilot services within China. The basic tax rate is 6%, 11% or 17%.

Business Tax (BT)

- Imposed on the entity and/or individual engaged in providing taxable services, transferring intangible assets or selling immovable property within China. The tax rate applicable to the entertainment industry is 20% (billiards clubs and bowling halls is 5%), 3% or 5% applies to other industries.

Consumption Tax (CT)

- Imposed on the entity and/or individual engaged in producing, consigned processing, or importing taxable consumer goods within China. The CT covers 14 tax items such as tobacco (i.e. cigar 36%), alcoholic drinks and alcohol (5%), cosmetics (30%), jewelry (5%) and precious stones.

Corporate Income Tax (CIT) / Enterprise Income Tax

- Resident enterprises pay the enterprise income tax for their income sourced within and outside of China. Non-resident enterprises shall pay the enterprise income tax based on i) whether they have organizations or establishments within China, and ii) whether the income is in fact related to such organizations or establishments. The tax rate is 25%, enterprise income tax for R&D activities is 15%. Some of transactions are subject to advanced withhold tax of 10%.

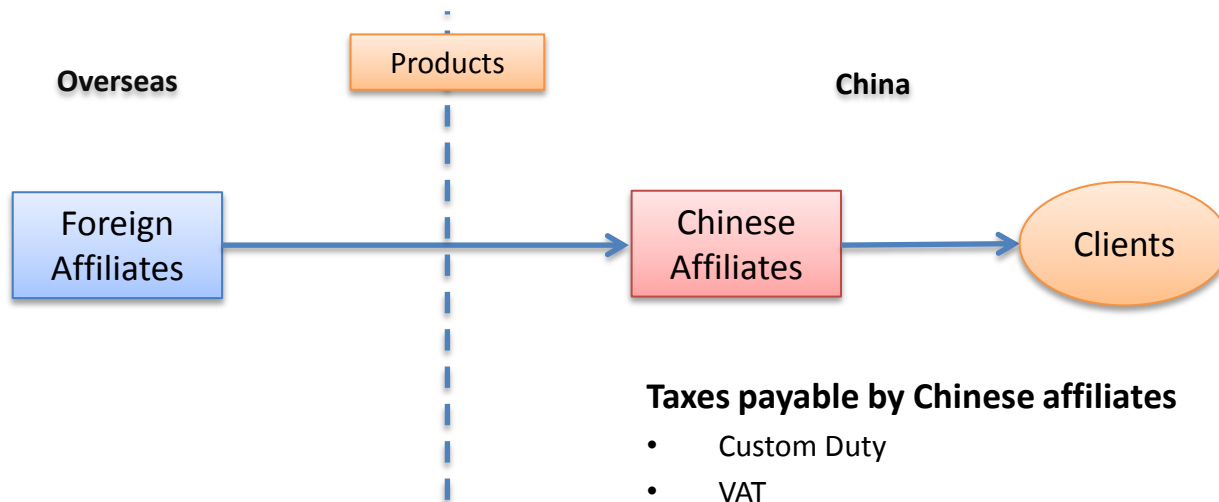
City Maintenance and Construction Tax and Education Surcharge (CMCT&ES)

- The surcharges are calculated as a percentage of the VAT/BT and CT due. The ES is levied at a flat rate at 3%, while the rates for CMCT differs depending on the location of the taxpayer: 7% for taxpayers located in a city; 5% for taxpayers located in a county and town area; and 1% for taxpayers located in other regions.

If one (VAT/BT) applies, the other does not

Note: Tax categories are not covered in this presentation are: individual income tax, resource tax, urban and township land use tax, house property tax, tax on the use of farm land, land appreciation tax, and tobacco leaf tax.

TRANSACTION 1: FOREIGN AFFILIATES SELL PRODUCTS TO CHINESE AFFILIATES



Taxes payable by Chinese affiliates

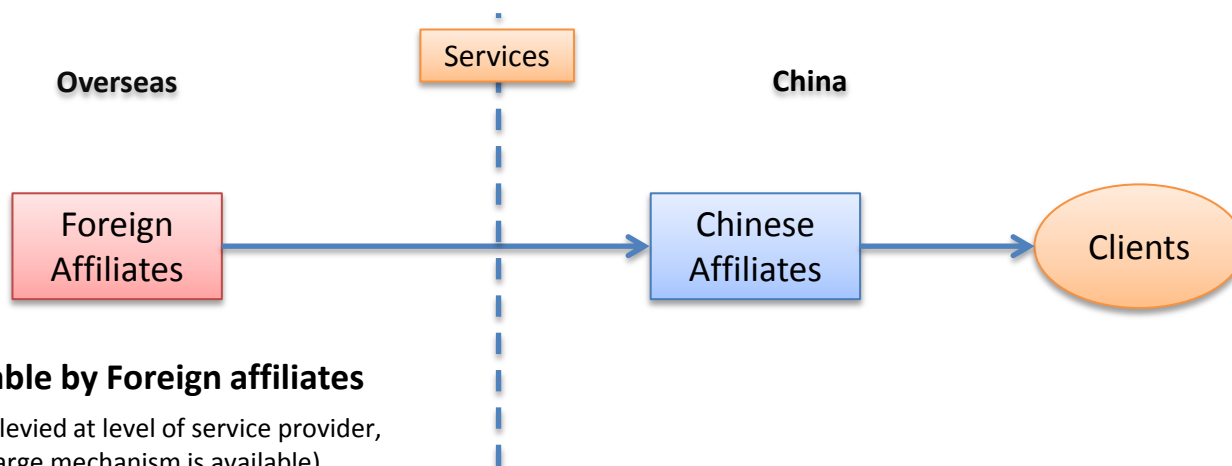
- Custom Duty
- VAT
- Consumption Tax (e.g. tobacco, alcohol, cosmetics etc.)
- Transfer Pricing (TP) rules: the price of purchased products consistent with the arm's length principle
- Exemptions: tax incentives (example)

Example: Chinese OLED Manufacturer imports raw materials which cannot be produced in China

- Custom Duty: 0 (tax exemption)
- VAT: 17%
- Consumption tax : not applicable

Source: *Cai guan shui [2012] No. 16*

TRANSACTION 2: FOREIGN AFFILIATES PROVIDE SERVICES TO CHINESE AFFILIATES



Taxes payable by Foreign affiliates

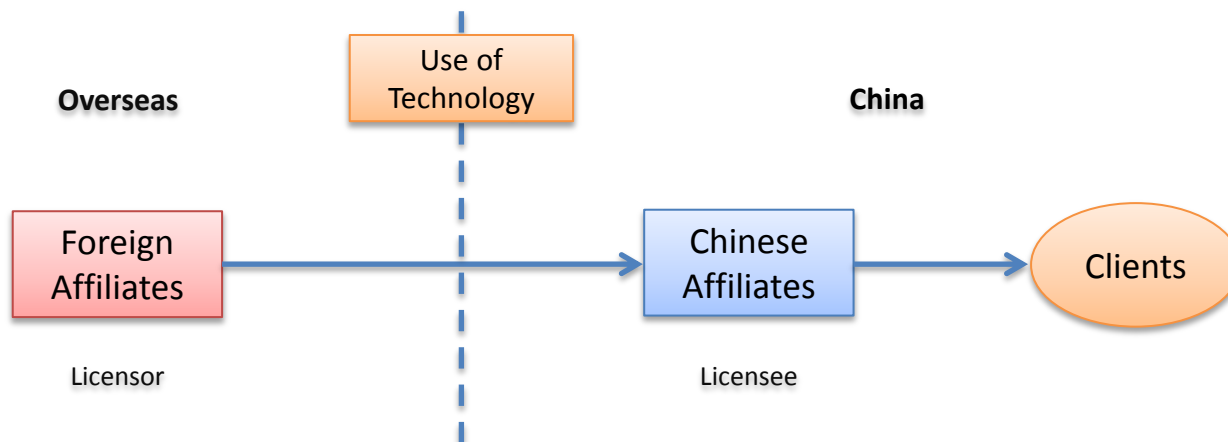
- VAT / BT (levied at level of service provider, reverse charge mechanism is available)
- CMCT&ES
- CIT (may applicable, see table below)

Types	VAT	or	BT	CIT*
Services provided outside China	No		No	No
Services provided in China but no PE of Foreign Affiliates	x (VAT Pilot, 6%)		x (No VAT Pilot, 5%)	No
PE of Foreign Affiliates in China	x (VAT Pilot, 6%)		x (No VAT Pilot, 5%)	x (25%)

- **VAT Pilot:** under this program, BT will be replaced by VAT, this pilot is effective from August 1, 2013 on a nationwide basis.
- **"1+7" industries:** See [Appendix 2](#) for details

* CIT consequences at the level of Chinese Affiliates: i) Arm's Length Principle of the cost of services; ii) withholding tax.

TRANSACTION 3: FOREIGN AFFILIATES PROVIDE TECHNOLOGY TO CHINESE AFFILIATES



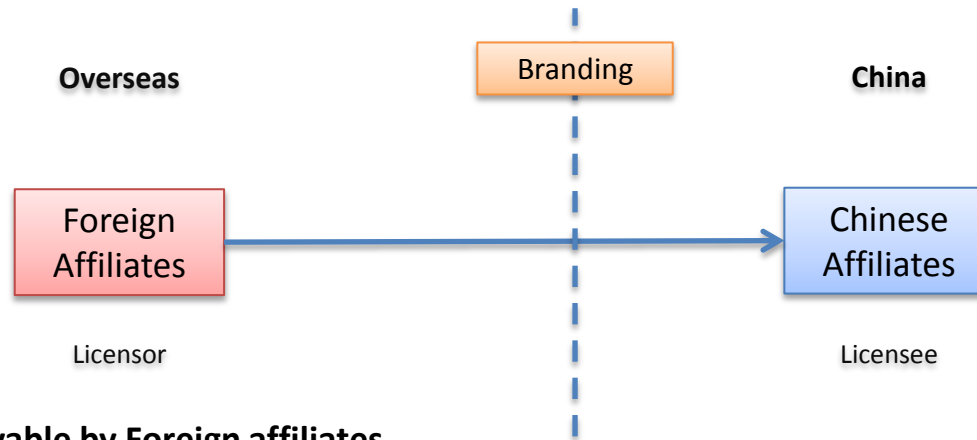
Taxes payable by Foreign affiliates

- BT/VAT: Tax exemption
- CIT (withholding tax): 10%/depending on tax treaty
- CIT (TP): Price Arm's Length Principle

- If use of technology is in "1+7" industries, than only VAT applies
- An explicit request for tax exemption of VAT/BT needs to be filed
- **Example:** KFC China uses the software designed by foreign affiliates, royalty article is applicable but not applicable when the technology is outdated

- "Uniqueness" of technology for application of the royalty rate: Guoshuihan [2009] No. 507
- Royalty rate paid for use of technology can be deducted by Chinese affiliates for CIT purpose

TRANSACTION 4: FOREIGN AFFILIATES PROVIDE BRANDING TO CHINESE AFFILIATES



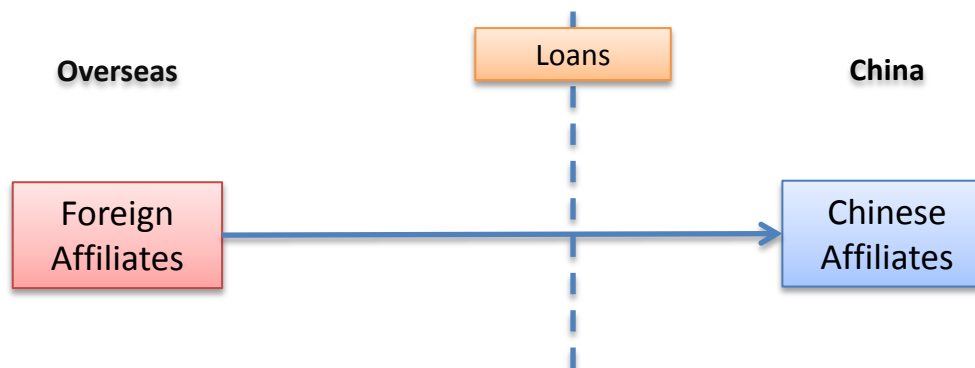
Taxes payable by Foreign affiliates

- BT (WHT): 5%
- CMCT&ES
- CIT (Royalty fee): 10%/depending on Tax treaty
- CIT (TP): Price Arm's Length Principle

Example: Coca Cola US licenses its brand to Chinese associated entities whereas

- Coca Cola Japan pays 7% royalty fee ;
- Coco Cola China pays less than 7% as the Chinese name for Coca Cola is used.

TRANSACTION 5: FOREIGN AFFILIATES LEND LOANS TO CHINESE AFFILIATES

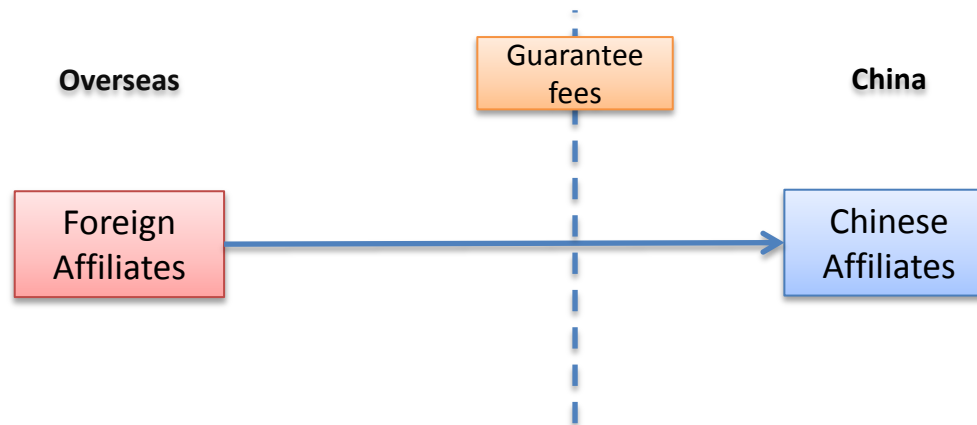


Taxes payable by Foreign affiliates

- BT (WHT on interest): 5% (levied on interest)
- CMCT&ES
- CIT (WHT on interest): 10%/depending on Tax treaty
- CIT (TP): i) Thin capitalization (debt/equity ratio: 2:1 maximum); ii) interest not exceeding the basic lending rates can be deductible for CIT purpose

Example: Overseas payment between two associated corporates
Principle loan equals to \$100 million, interest 6% (not exceeding the basic lending rates published by the People's Bank of China)
Chinese affiliate pays \$6 million

TRANSACTION 6: FOREIGN AFFILIATES CHARGE GUARANTEE FEES FROM CHINESE AFFILIATES

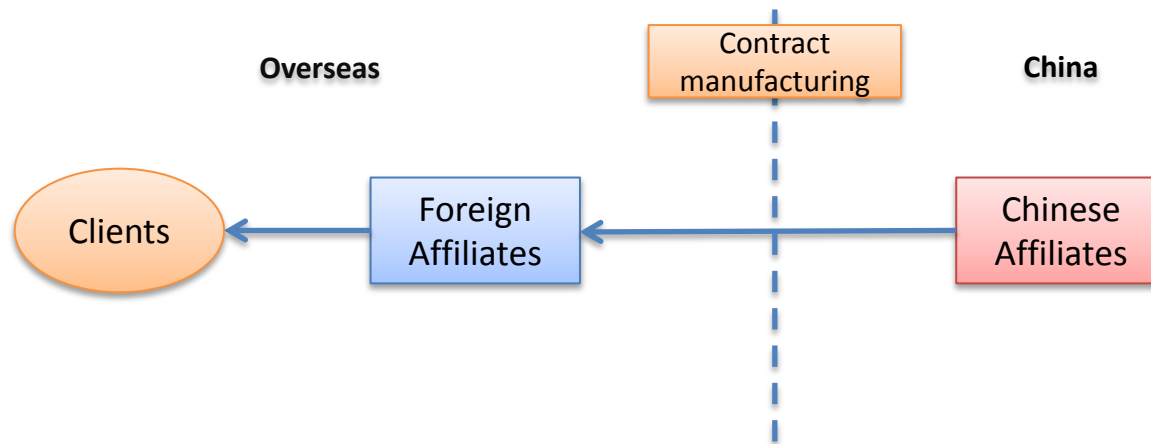


Taxes payable by Foreign affiliates

- BT (WHT): 5%
- CMCT&ES
- CIT (WHT): 10% / Tax treaty
 - SAT public notice [2011] No. 24 (guarantee treated as interest)
- CIT (TP): same as interest

Example: Philips Netherlands (Guarantor) VS Philips China (Guarantee)
Guarantee fee 50 basis points

TRANSACTION 7: CHINESE AFFILIATES PROVIDE CONTRACT MANUFACTURING ACTIVITIES TO FOREIGN AFFILIATES



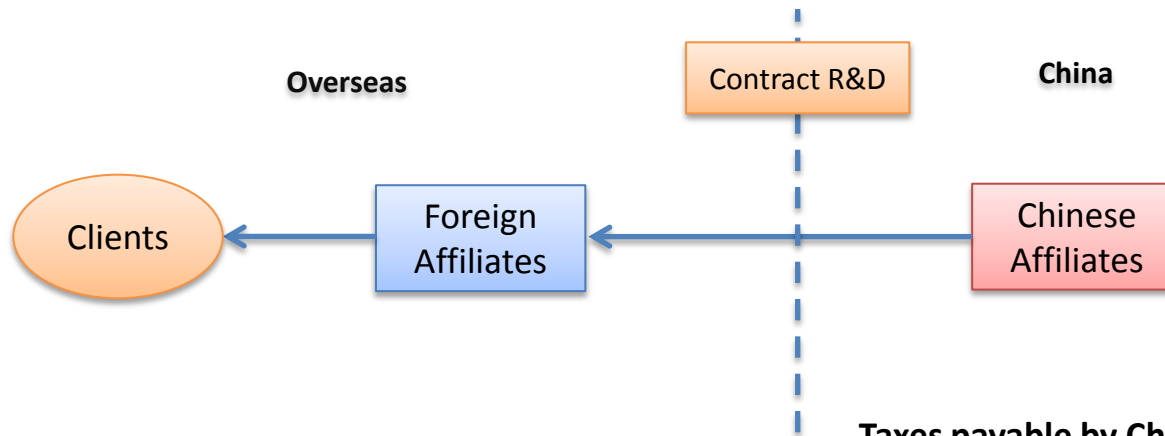
Taxes payable by Chinese affiliates

- VAT (fully or partially tax refund)
- CMCT&ES
- CIT: 25%
- CIT (TP): remain low but reasonable profits at arm's length principle

Example: Optical disk exports

- VAT: 17% (tax refund 13%)
- CMCT&ES: 1.7% = 17%*(7%+3%)
- CIT: 25%

TRANSACTION 8: CHINESE AFFILIATES PROVIDE CONTRACT R&D SERVICES TO FOREIGN AFFILIATES



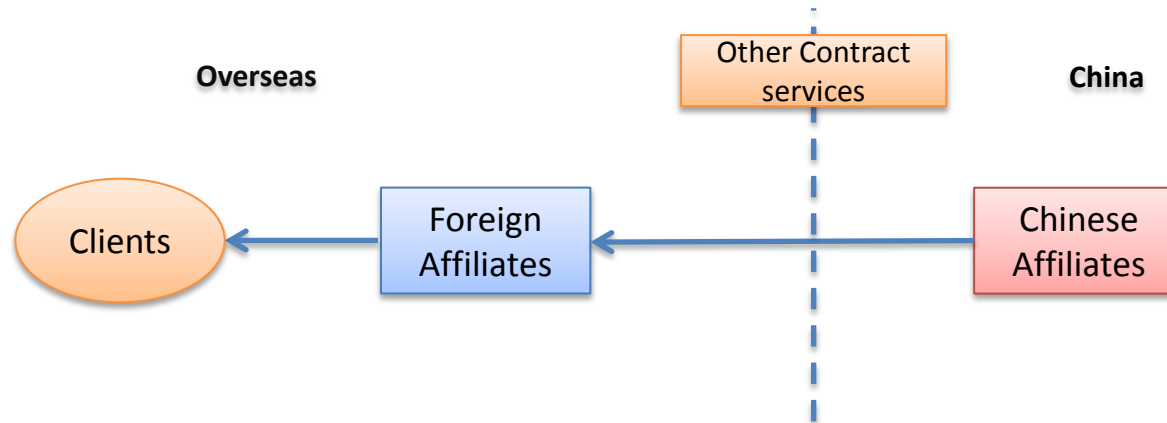
Taxes payable by Chinese affiliates

- VAT: (0% tax rate, Caishui [2003] No. 37)
- CIT: 25% Or
 - Transfer of technology: tax exemption under 5 million yuan; 12.5% above 5 million yuan
 - HNTE: 15%
 - DSE: tax exemption for first 2 years; 12.5% for following 3 years
 - TASE: 15%
- CIT (TP): remain reasonable profits at arm's length principle

HNTE: High and New Technology Enterprise
 DSE: 'Double Soft' Enterprise
 TASE: Technology Advanced Service Enterprise

Example: HNTE center in China, Chinese affiliate provides:
 VAT: 0%
 CIT: 15%

TRANSACTION 9: CHINESE AFFILIATES PROVIDE OTHER CONTRACT SERVICES TO FOREIGN AFFILIATES



Taxes payable by Chinese affiliates

- VAT (tax exemption) or BT (5%/tax exemption)
- CMCT&ES
- CIT: 25%
- CIT (TP): remain reasonable profits at arm's length principle

Example: Intellectual Property Registration Services

- VAT: tax exemption
- CMCT&ES: 0
- CIT: 25%

APPENDIX 1 – CHINESE TAX ISSUES OF CROSS-BORDER INTERCOMPANY TRANSACTIONS

Chinese Tax Issues of cross-border Intercompany Transactions										
Division	Type of transactions		Taxpayer	Custom tax	VAT	Business tax	CMCT&ES	Consumption tax	CIT	Remarks (check if tax treaty available)
Inbound inter-company transactions	1. Products		Chinese Affiliates	x (tax incentive)	x (tax incentive)			x (tax incentive)		
	2. Services	Services provided outside China	Foreign Affiliates		No	No			No	
		Services provided in China but not PE			x (VAT Pilot, 6%)	x (No VAT Pilot, 5%)	x (if BT charges)		No	TAX treaty
		PE in China			x (VAT Pilot, 6%)	x (No VAT Pilot, 5%)	x (if BT charges)		x (25% tax rate)	TAX treaty
	3. Technology		Foreign Affiliates		VAT Pilot (Tax exemption)				x WHT (withholding tax):10%	TAX treaty
	4. Branding		Foreign Affiliates			x WHT: 5%	x		x WHT (Royalty Fee): 10%	TAX treaty
	5. Loan		Foreign Affiliates			x WHT: 5%	x		x WHT (Interest): 10%	TAX treaty
6. Guarantee fees		Foreign Affiliates			x WHT: 5%	x		x WHT (similar to Interest):10%	TAX treaty	
Outbound inter-company transactions	7. Contract manufacturing		Chinese Affiliates		x (tax refund)		x (No tax refund)		x CIT: 25%	
	8. Contract R&D		Chinese Affiliates		x (VAT Pilot, 0%)				x CIT (tax incentive)	
	9. Other contract services		Chinese Affiliates		x (VAT Pilot, 0%)	x 5%	x (if BT charges)		x CIT:25%	

APPENDIX 2 – TAXABLE SERVICES UNDER CHINA’S VAT PILOT

Taxable Services Under China's VAT Pilot		
Services Industry	Scopes	Tax Rate
Transportation service industry	Land transportation service	11%
	Water transportation service	11%
	Aviation transportation service	11%
	Pipeline transportation service	11%
Modern service industry	R&D and technology service	6%
	Information technology service	6%
	Cultural and creative service	6%
	Logistics auxiliary service	6%
	Tangible movable property leasing service	17%
	Authentication and consulting service	6%
	Broadcasting, film, and television services	6%

Effective from 1 August, 2013

APPENDIX 3 – TRANSFER PRICING RELEVANT PUBLICATIONS BY CHINESE STATE ADMINISTRATION OF TAXATION

- + Implementation Measures of Special Tax Adjustments, Guoshuifa [2009], No. 2
- + Circular of the State Administration of Taxation on Strength Cross-order Connected Transactions, Guoshuihan [2009], No. 363
- + Notice regarding certain issues related to CIT, SAT Announcement [2011], No. 34
- + Intercompany payments between multinational corporations and their affiliated companies in China, Guoshuifa [2008], No. 86
- + Notice of the State Administration of Taxation on Simplifying the Determination of the Actual Tax Rate of the Country where the Foreign Corporation Controlled by Chinese Resident Shareholder Resides, Guoshuihan [2009], No. 37
- + Notice on the Recognition of Overseas Incorporated Domestically Controlled Enterprises as PRC Resident Enterprises Based on the Place of Effective Management Criteria, Guoshuifa [2009], No. 82
- + Notice of the State Administration of Taxation on Intensifying the Transfer Pricing Follow-up Administration, Guoshuihan [2009], No. 188
- + Notice on Strengthening the Monitoring and Investigation of Cross-Border Related-Party Transactions, Guoshuihan [2009], No. 363
- + Notice Releasing the Annual Report of Related-Party Transactions of the People’s Republic of China, Guoshuifa [2008], No. 114
- + Notice of the SAT on Certain Issues concerning the Implementation of the Articles on Royalty Payments in Tax Treaties, Guoshuihan [2009], No. 507
- + Notice of the SAT regarding understanding and recognition of “Beneficiary Owner” under tax treaties, Guoshuihan [2009], No. 601
- + Notice on Conducting Examinations of Contemporaneous Documentation, Guoshuihan [2010], No. 323
- + Notice regarding interpretations for provisions in the China-Singapore Double Tax Agreement, Guoshuifa [2010], No. 75

Thank you!

Ling Zhang

Transfer Pricing Associates

Amsterdam, The Netherlands

Email: l.zhang@tpa-global.com

Tel: +31(0)20 262 2988

Zhiqun Shi

Founding Partner, MinterPKU

Beijing, China

Email: Zhiqun.shi@minterpku.com

Tel: +86(0)10 5900 9170 ext 808

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+31 20 462 3530 | www.tpa-global.com | info@tpa-global.com

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