



## **NEWSLETTER 2**

FOCUS CHINA TAX

**JULY 2015**

### **CHINA**

- **Individual Income Tax Treatment ("IIT") of Nonmonetary Assets Investment by Individuals**
- **Strengthens Service Fees and Royalties Payment to Overseas Related Parties**

## **I. Individual Income Tax Treatment ("IIT") of Nonmonetary Assets Investment by Individuals**

China State Administration of Taxation ("SAT") issued Circular Caishui [2015] No. 41 that clarifies the IIT treatment of contribution of nonmonetary assets ("Circular 41") and SAT Bulletin [2015] No. 20 ("Bulletin 20") as the implementation rule of Circular 41 and both regulations are effective from April 1, 2015.

Based on Circular 41, the definition of nonmonetary assets and nonmonetary assets investment are stipulated as follows:

1. nonmonetary assets mainly refer to equity interest, real estate, technology, and other nonmonetary assets excluding the cash and bank deposit.
2. nonmonetary assets investment refer to the use of nonmonetary assets to establish a new enterprise or to participate in investment activities, such as

capital increase, non-public, targeted issuance of additional shares, restructuring, etc..

Circular 41 provides that nonmonetary assets investment should be treated as two simultaneous transactions:

1. The investment: based on the current relevant regulations, value added tax and business tax are exempt for the investment using most nonmonetary assets by individuals for the moment, but the detailed tax implications need to be considered case by case.
2. A transfer of nonmonetary assets:

Gains derived by an individual from the transfer of nonmonetary assets must be calculated as “gains from the transfer of property”, and according to IIT regulation, 20% IIT needs to be imposed on the gains from the transfer of property.

Regarding the calculation of IIT income, Circular 41 provides that the taxable income is the assessed fair market value of these assets less the “original cost” of the assets (i.e. actual expenditure incurred on the assets when the taxpayer acquired the assets) and “reasonable taxes and surcharges” (i.e. the taxes and surcharges arising during the course of nonmonetary assets investment, provided that they are relevant and reasonable)

Regarding the taxpayer, Bulletin 20 stipulates that the individual making the investment using the nonmonetary assets within the enterprise needs to file and pay the tax by himself, and the enterprise has the reporting obligation.

In the meantime, Circular 41 permits a taxpayer to pay tax by installment in the five years following the day on which the taxable activity took place if the taxpayer has difficulties in paying the tax in full.

It is suggested that individuals who plan to make nonmonetary assets investment in China should evaluate the potential impact of Circular 41 and Bulletin 20 to determine how to take advantage of the installment payment option and how to reduce any potential tax risks.

## **I. Strengthens Service Fees and Royalties Payment to Overseas Related Parties**

China's State Administration of Taxation (“SAT”) released Bulletin [2015] No. 16 (“Bulletin 16”) which is effective from March 18, 2015, and is related to service fees and royalties being paid to overseas related parties by Chinese enterprises. Bulletin

16 emphasizes the authenticity and arm's length nature of service and royalty transactions within intercompany agreements and other supporting information.

Bulletin 16 illustrates four types of intra-group payments that are not deductible for Enterprise Income Tax ("EIT") purpose:

- 1) Payments to overseas related parties that neither assume functions and risks nor have economic substance;
- 2) Payments for services that are unable to bring direct or indirect economic benefits to the service recipient, such as:
  - Services that are irrelevant to the functions and risks undertaken or business operated by the service recipient;
  - control, management and supervision activities undertaken by related parties to oversee direct or indirect investments in the service recipient; etc.;
  - Services that have already been purchased from third parties or provided in-house by the service recipient;
  - No services were specifically provided to the service recipient, although the service recipient may benefit incidentally from a group benefit;
  - Services that have been remunerated through other related party transactions;
  - Other services that fail to produce direct or indirect benefits to the service recipient
- 3) in order to determine the economic benefit each party is entitled to in cases of royalties to be paid to an overseas related party, consideration must be taken as to the contribution to the intangible assets made by the relevant related parties. Royalty payments to related parties who merely possess the legal ownership but fail to contribute to the value creation of the intangibles are not deductible.
- 4) Royalties for incidental benefits from financing activities paid to overseas holding companies or financing companies for the purpose of financing and listing may not be deductible.

The consequence for non-deducting of overseas payment before EIT is that the taxable income will be increased, and considering the EIT rate is normally 25%, the relevant EIT implication may be important. In addition, based on Bulletin 16, the tax authorities will have the right to perform a tax adjustment on any payment to overseas related parties within a period of 10 years.

Thus, we can see that Chinese tax authorities have strengthen the intra-group services charges and royalties, and it is suggested to

- 1) prepare supporting documents, such as transaction flow, written delivers of the relevant service, and pricing policy, etc.;
- 2) review the economic substance of each type of the service fees;

3) review the legal and economic ownership of intellectual property, and prepare supporting documents to justify the contribution to the intellectual property; etc..

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