

## Tax

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# Tax Analysis

## New Guidance Clarifies Rules Relating to EIT Withholding on China-Source Income Derived by Nonresident Enterprises

China's State Administration of Taxation (SAT) published guidance (Bulletin [2017] No. 37 (Bulletin 37)) on 27 October 2017 that revises the rules governing the administration of withholding tax on China-source income derived by nonresident enterprises (NREs).

Bulletin 37 is accompanied by a helpful official interpretation of the new rules, which contains a detailed discussion of key issues, as well as specific examples. The Bulletin provides clearer guidance on the collection of enterprise income tax (EIT) on China-source income derived by NREs and resolves some practical issues that have existed until now. It also includes measures to reduce the administrative burden on withholding agents, coordinate responsibilities among different tax authorities and generally improve the business environment.

Bulletin 37 repeals previous guidance issued in 2009, "Interim Administrative Measures on the Collection of Withholding Income Tax on Nonresident Enterprises" (Guoshuifa [2009] No. 3 (Circular 3)) and the "Notice on Strengthening the Administration of EIT for Income Derived by Nonresident Enterprises from Equity Transfers" (Guoshuihan [2009] No. 698 (Circular 698)), as well as some relevant articles in other circulars.

The issuance of Bulletin 37, which is welcome news for both NREs and withholding agents, generally will apply as from 1 December 2017. However, three provisions also will apply to income that has arisen but not been dealt with before the effective date.

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The main features of Bulletin 37 are as follows:

- Abolition of the requirement for withholding agents to submit contracts to the Chinese tax authorities within 30 days after a contract was signed or amended;
- Clarification that EIT on dividend payments must be withheld on the actual payment date rather than the day on which the distribution decision was made by the board of directors;
- Time at which an NRE is required to report and pay tax on its own;
- Specification of situations where a withholding agent will be deemed to have withheld tax but not paid the tax to the tax authorities (as opposed to not having withheld the tax at all);
- Clarification of the duties and cooperative practices that apply among the Chinese tax authorities involved in EIT withholding;
- Clarification of the foreign currency exchange rules and other issues relating to the calculation of taxable income.

Using a Q&A format, this article summarizes and analyses the key points of the Bulletin.

**Q1: Circular 3 provides that a withholding agent must submit the relevant contract to the competent tax authorities within 30 days from the date the contract was signed or amended. This requirement is not included in Bulletin 37, so is the filing requirement abolished?**

**A1: Yes, Bulletin 37 abolishes the above requirement. However, the competent tax authorities still have the right to request the contract from the agent.**

Under Circular 3, where a contract involving the withholding of EIT was concluded or amended, the withholding agent is required to complete the "Registration Form for Contracts for Withholding of EIT" and submit the form, the contract and other documents to the Chinese tax authorities within 30 days from the date the contract was signed or amended.

Bulletin 37 effectively eliminates the above contract registration requirement by repealing Circular 3 in its entirety, thus reducing the administrative burden on withholding agents. This change is consistent with the abolition of the contract registration requirement in the NRE tax withholding procedures as found in article 2(1), paragraph 4 of the recently issued "Opinions on Further Deepening the Tax Administrative Reform of 'Delegating Powers, Strengthening Regulation and Enhancing Tax Services' to Improve the Tax Environment" (Shuizongfa [2017] No. 101). Nevertheless, under Bulletin 37, withholding agents still will be required to maintain proper files relating to the relevant contracts, and the tax authorities will have the right to request a contract from a withholding agent.

In addition, withholding agents and NREs should be aware of other rules that require contracts to be submitted to the tax authorities, such as the following:

- Bulletin of the SAT and the State Administration of Foreign Exchange (SAFE) on Issues Relating to Tax Filing for Outbound Payments of Trade in Services (Bulletin of the SAT and the SAFE [2013] No. 40);
- Administrative Measures on the Entitlement of NREs to Tax Treaty Benefits (Bulletin of the SAT [2015] No. 60);

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- Bulletin of the SAT on Several Issues Relating to EIT on Indirect Transfers of Assets by Nonresident Enterprises (Bulletin [2015] No. 7); and
- Notice of the SAT on the Cancellation of a Number of Tax-related Matters and the Submission of Information" (Shuizonghan [2017] No. 403).

**Q2: Where a Chinese resident enterprise distributes dividends to its nonresident shareholders, must the Chinese payer withhold the EIT on the date the profit distribution decision is made or on the date the payment is made?**

**A2: The EIT must be withheld on the actual payment date.**

According to article 5 of the "Bulletin of the SAT on Several Issues Relating to the Administration of Income Tax on Nonresident Enterprises" (Bulletin of the SAT [2011] No. 24), where a Chinese resident enterprise pays dividends to an NRE that does not have an office or premises in China, the resident enterprise is required to withhold the EIT on the earlier of the date on which the decision was made by the board of directors to distribute the profits or the date the payment was made. Bulletin 37 abolishes article 5 of Bulletin 24.

Bulletin 37 clarifies that the withholding obligation on dividends received by an NRE is triggered only on the actual payment date. This provision will have retroactive effect.

In instances where a resident enterprise actually pays dividends after the date the profit distribution decision was made, Bulletin 37 will be more beneficial for withholding agents and NREs.

**Q3: Where a withholding agent fails to withhold EIT, is the NRE required to report and pay the tax to the Chinese tax authorities and, if so, when?**

**A3: Where a withholding agent fails to withhold EIT or is unable to do so, the NRE recipient of the income must report and pay the tax to the competent authorities located in the place where the income is derived. The date the NRE must report and pay the tax is as follows:**

1. Where the NRE does not voluntarily report and pay the tax, the competent tax authorities may request the NRE to pay the EIT within a prescribed period, and the NRE must comply; and
2. Where the NRE voluntarily reports and pays the tax before the competent tax authorities request payment within a prescribed period, the date on which the tax payment is made will be deemed to be the due date of such tax payment.

The above provisions have retroactive effect.

Where a withholding agent fails to withhold EIT, the current rules contain strict time requirements for an NRE to report and remit the tax to the Chinese tax authorities on its own (with late payment interest imposed for noncompliance):

- *Circular 3*: Within seven days from the date the payment is made by the withholding agent or seven days from the date the payment becomes payable;
- *Circular 698*: Within seven days from the date of the share transfer as prescribed in the relevant contract or from the date of the receipt of the income.

The new rule in Bulletin 37 is more beneficial to taxpayers. Where an NRE voluntarily reports and pays the tax to the Chinese tax authorities before being requested to do so, the date on which the tax payment is made will be deemed to be the due date of such tax payment. As a result, late payment interest will not be levied where the NRE reports and pays the tax on its own initiative. It also appears that late payment interest may not be levied even where the competent tax authorities set a date for the tax payment for the first time and the NRE complies. The new rule evidences the SAT's encouraging attitude towards voluntary reporting by NREs.

**Q4: In cases where the withholding agent does not remit the EIT to the Chinese tax authorities, how can a situation where "the withholding agent is considered to have withheld the tax but not paid the tax to the tax authorities" be distinguished from a situation where the "withholding agent is considered not to have withheld tax at all"?**

**A4: Bulletin 37 provides the following guidance on how to distinguish the two situations:**

Where the income has been paid to the NRE, but the withholding agent did not remit the tax to the Chinese tax authorities, and any one of the following circumstances is present, the withholding agent will be considered "to have withheld the tax but not paid the tax to the tax authorities":

- The withholding agent expressly informs the payee that the tax was withheld;
- The amount of the tax payable is booked as a separate item in the withholding agent's accounting ledger;
- The amount of the tax payable is deducted or starts to be amortized as a separate item in the withholding agent's tax filing; or
- There is other evidence that the tax actually was withheld.

In all other cases, the withholding agent will be deemed not to have withheld the tax at all.

According to PRC Tax Collection and Administration Law, the legal consequences for the withholding agent in the above two situations are different.

**Q5: Where an amount that is paid or becomes payable by a withholding agent is in a foreign currency, what is the exchange rate for converting the foreign currency into RMB to compute taxable income?**

**A5: Bulletin 37 distinguishes the following three situations:**

1. Where the agent withholds the tax, the foreign currency should be converted into RMB based on the median exchange rate published on the day the withholding obligation arises. Circular 3 describes the exchange rate as the median rate published "on the day the tax was withheld," which has been interpreted being either the date the withholding obligation was triggered or the actual tax payment date. The new rules in Bulletin 37 clarify that this refers to the day the withholding obligation is triggered;
2. Where an NRE reports and pays the EIT voluntarily before the tax authorities request the tax payment, the foreign currency will have to be converted into RMB based on the median exchange rate published "on the day before the day on which the tax payment form is completed."
3. Where the competent tax authorities request the NRE to pay the tax within a prescribed period, the median exchange rate published "on the day before the day on which the tax authority makes the decision to request the tax payment" will apply.

**Q6: How will taxable income be calculated where the currency of the proceeds of a transfer of Chinese assets is different from the currency in which the assets were acquired?**

**A6: Bulletin 37 provides that if the proceeds and/or the cost of the assets are in foreign currencies, they will have to be converted directly into RMB to compute taxable income.**

In computing income from an equity transfer, Circular 698 requires the transfer price to be converted into the currency in which an NRE first made the investment or purchased the equity, so that the taxable income from the transfer can be calculated in that currency before being converted into RMB.

For example, assume an NRE indirectly obtained shares of a Chinese company in AUD and then sold the shares in USD, the foreign currency conversion under Circular 698 was as follows:

- ① Share transfer price: USD  $\longrightarrow$  AUD<sub>1</sub>
- ② Cost of shares: AUD<sub>2</sub>
- ③ Share transfer gain in AUD: AUD<sub>1</sub> - AUD<sub>2</sub> = AUD<sub>3</sub>
- ④ Share transfer gain in RMB: AUD<sub>3</sub>  $\longrightarrow$  RMB

Bulletin 37 provides that, to compute the taxable income, the price and/or the cost of the assets in the foreign currency will have to be converted directly into RMB. The exchange rate to be used follows the same standard as discussed in Q&A 5 above.

Under the new rules, the foreign currency conversion for the above example will be as follows:

- ① Share transfer price:           USD  $\longrightarrow$  RMB<sub>1</sub>
- ② Cost of shares:                AUD  $\longrightarrow$  RMB<sub>2</sub>
- ③ Share transfer gain in RMB:   RMB<sub>1</sub> – RMB<sub>2</sub> = RMB<sub>3</sub>

#### Q7: To which tax authorities should the withholding agent or NRE report and pay the EIT?

**A7: Where the agent withholds tax, the tax will have to be reported and paid to the "competent tax authorities in the place where the agent is located." Where an NRE reports and pays the tax, the tax will have to be paid to the "competent tax authorities in the place where the income is derived."**

Bulletin 37 puts the competent tax authorities into two categories:

1. The "competent tax authorities in the place where the agent is located" will be the authorities in charge of the withholding agent's income tax;
2. The "competent tax authorities in the place where the income is derived" are as follows:
  - For income derived from the transfer of immovable property, the state tax bureau in the place where the property is located;
  - For gains derived from a transfer of an equity investment, the tax authorities in charge of the invested enterprise's income tax;
  - For dividends, the tax authorities in charge of the distributing entity's income tax; and
  - For interest, rents and royalties, the tax authorities in charge of the income tax of the enterprise or individual that bears or pays the relevant income.

Since there may be multiple tax authorities involved in the collection of EIT subject to withholding, guidance is needed to specify the duties of the various authorities. For instance, in an equity transfer, if the buyer is a resident entity in Beijing and invested enterprise being transferred is in Shanghai, the place where the withholding agent is located and the place where the income is derived are different.

To clarify responsibilities among the tax authorities in such situations, Bulletin 37 provides the following rules:

- If a withholding agent does not withhold the tax at all, the competent tax authorities in the place where the withholding agent is located will have to pursue the liability of the agent in accordance with the relevant laws and regulations. If it is necessary to recover the tax payment from the NRE, the tax authorities in the place where the income is derived should do so;
- If the location of a withholding agent is different from the place where the income is derived, and the competent tax authorities in the place where the income is derived are responsible for collecting the tax, those authorities will be responsible for verifying the relevant information with the competent tax authorities in the place where the withholding agent is located;
- If the competent tax authorities in the place of the withholding agent have confirmed that the tax was not withheld and paid by the withholding agent, these tax authorities will have to notify the competent tax authorities in the place where the income is derived about the tax issues related to the NRE by sending a letter within five business days from the date of such confirmation.

The above rules aim to facilitate coordination among the different tax authorities.

**Q8: Do Bulletin 37 and the official interpretation include any other major clarifications?**

**A8: Bulletin 37 provides two other major clarifications that will be beneficial to taxpayers:**

1. When shares in other entities obtained via more than one investment or purchase are transferred in part, the cost of the shares transferred will have to be calculated based on the ratio of the amount of the shares transferred to the total amount of the shares held by the transferor before the transfer (article 3 of the official interpretation contains an example);
2. When an NRE receives income from an asset transfer via installment payments, the payments will be considered first as the recovery of the NRE's investment cost, and the EIT will have to be calculated and withheld after all costs have been recovered (article 7 of the official interpretation contains an example). This provision has retroactive effect.

**Comments**

Bulletin 37 provides clear and updated guidance on the collection of EIT on China-source income derived by NREs, which should make tax collection more efficient. Since Bulletin 37 makes a number of significant changes to previous rules, parties involved in transactions that have not yet been taxed and parties that are considering relevant transactions should have a thorough understanding of Bulletin 37, analyze the relevant tax implications and take steps needed to mitigate any potential tax risks.

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