China Provides Further Guidance for Chinese Outbound Investment

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On 10 June 2010, the China State Administration of Taxation (SAT) issued a tax circular, *Opinion Regarding Improvement of the Tax Service and Administration for Chinese Enterprises "Going Outbound"*, Guo Shui Fa [2010] No. 59 (Circular No. 59). The circular addresses tax developments pertaining to outbound investment by Chinese enterprises as well as suggestions for local tax authorities to improve tax administration and service. The circular also provides guidance with respect to anticipated legislation and administrative developments relating to outbound investments, including potential reporting compliance requirements and anti-abuse provisions.

Background

One of the most significant strategic decisions made by China's central government, the State Council, has been to encourage Chinese enterprises to invest outward (or "go outbound") and make use of overseas resources, markets and advanced technologies to facilitate development of China's domestic economy.

According to a report from the Seventeenth National Congress of the Communist Party, China is committed to the opening-up policy and will continue to encourage outbound investment in combination with its policy of attracting foreign investment.

A national tax meeting was convened by the SAT to develop ideas to support Chinese outbound investment strategy. In order to better support Chinese enterprises going outbound (outbound enterprises), the SAT issued Circular No. 59 to improve tax administration and governmental services for outbound enterprises.

Proposed Actions by Tax Authorities Pursuant to Circular No. 59

According to Circular No. 59, the tax authorities will develop or improve certain tax policies consistent with the principles already embedded in existing income tax or turnover tax regulations to better support outbound enterprises. The following are key provisions of Circular No. 59 and its interaction with certain other current tax developments.

FURTHER DEVELOPMENTS ON THE FOREIGN TAX CREDIT (FTC) MECHANISM

Chinese multinational enterprises are generally entitled to the FTC for taxes paid in jurisdictions outside China. Circular No. 59 emphasises the development of detailed implementation guidelines regarding the FTC mechanisms. The principles have already been described in the Corporate Income Tax (CIT) law, its Detailed Implementation Rules (DIR), and the *Circular Regarding Certain Issues on Foreign Tax Credit of Corporate Income Tax* (Caishui [2009] No. 125 (Circular No. 125)).

A short background on the existing tax regulations regarding the FTC may be helpful. Generally, Chinese resident corporate taxpayers are subject to CIT on their worldwide income. Therefore, resident corporate taxpayers who derive foreign-source income are subject to CIT on any foreign-source income. To avoid double taxation, the FTC mechanism allows these taxpayers to claim an income tax credit for foreign taxes paid.

Generally, under the CIT law, the foreign income tax already paid in a foreign jurisdiction may be credited against the CIT payable by a Chinese enterprise in the attributable period. The FTC that can be claimed is limited to the CIT payable in respect of such income as calculated in accordance with the CIT law of China (FTC limitation). Any FTC in excess of the FTC limitation for an applicable tax year may be carried forward for no more than five years. The FTC carried forward can be utilised in future tax years to the extent that the FTC limitation for a tax year exceeds the amount of foreign tax paid on foreign source income for that year.

Circular No. 125, which was jointly issued by the Ministry of Finance (MOF) and SAT, has clarified certain technical issues regarding the FTC mechanism. However, some uncertainties remain, particularly from a practical perspective (*e.g.*, clarification is required with respect to computational methodology and disclosure details for overseas financial information).

On 2 July 2010, the SAT issued Operating Guidelines for the FTC (SAT Notice [2010] No. 1), which provide detailed guidance on certain aspects of the FTC rules, including as regards the calculation of foreign source taxable income, the rules for determining indirect shareholding, the FTC limitation and simplified calculation methods.

There are many considerations under the current FTC mechanism which Outbound Enterprises might take into consideration in terms of their existing or proposed outbound structures.

Pursuant to Circular No.125 and SAT Notice [2010] No. 1, the current FTC mechanism allows for two methods of calculating the FTC: a direct method and an indirect method. Under the direct FTC method, an enterprise can claim an FTC (subject to the FTC limitation) for the foreign income tax it paid on its foreign-source business profits as well as the withholding tax it paid for its foreign-source passive incomes. Under the indirect FTC method, a Chinese resident business can claim an indirect FTC for the foreign income taxes indirectly born by its foreign investee enterprise. However, the indirect FTC is limited to three tiers of foreign investee enterprises and there are certain minimum share holding percentage requirements.

Thus, those outbound enterprises that have or plan to have complex outbound investment structures may wish to review the number of tiers in their outbound structures with a view towards maximising their FTC. Conversely, those outbound enterprises with a simple outbound investment structures (*e.g.*, only a branch or single-tier structure for foreign investment) might consider imposing appropriate intermediary holding vehicles to receive a greater FTC benefit from both China and the foreign jurisdiction.

As another example, pursuant to the above FTC regulations, the timing of a tax resident enterprise's (TRE's) tax filing obligation for foreign-source income will differ depending on whether the TRE sets up a foreign branch (without independent tax status) or establishes an independent foreign subsidiary. Under the current FTC mechanism, the TRE establishing a foreign branch must include the current year's profits and income of the branch in its taxable income to calculate the CIT but can claim the FTC for income taxes. If the TRE establishes a subsidiary it will recognise the taxable foreign-source dividends (and claim an FTC with respect to those dividends under the indirect method) only when the subsidiary declares them.

Thus, an outbound enterprise may defer its Chinese tax obligation on foreign-source income by utilising a subsidiary rather than a branch, if the effective tax rate of the foreign jurisdiction is substantively lower than China's standard CIT rate (25 per cent) and the foreign subsidiary can temporarily retain its after-tax profits offshore. However, the outbound enterprise should also take into account other concerns such as the foreign tax implications with regard to branches and subsidiaries as well as other non-tax concerns, such as foreign exchange controls, in connection with this outbound planning.

SUPPORT FOR IMPORT AND EXPORT TAX POLICIES

Circular No. 59 announced that the tax authorities will further improve the import and export tax-refund policies related to outbound investment by outbound enterprises, and increase their support for further legislation on preferential import and export tax policies. Circular No. 59 is silent on what specific support the tax authorities would grant to outbound enterprises regarding import and export policies.

Uncertainties exist with regard to some areas of export tax policies. For example, according to existing tax regulations, outbound enterprises can normally obtain a tax refund on the value-added tax (VAT) for machinery and equipment purchased within China and transferred/contributed to their overseas subsidiary enterprises for use by such enterprises. However, since there currently is no clear guidance on whether such tax policies are applicable to inventories, the tax authorities in practice usually do not approve the tax refund of VAT for inventories contributed or otherwise transferred to overseas subsidiary enterprises. Therefore, such transfers could be treated as domestic sales and subject to VAT. It is not presently clear whether any new guidance will be issued soon to clarify or solve the above practical issue of unfavourable tax treatment for inventory investment.

In addition, in light of the recent cancellation of the VAT export refund for some products (mainly those that result in heavy pollution and high energy consumption), we believe additional guidance stemming from Circular No. 59 on this topic would likely focus on the VAT refund rates for equipment and machinery invested in overseas manufacturing and infrastructure construction projects. It remains to be seen whether more concrete rules will be issued in 2011.

FURTHER DEVELOPMENT OF INDIVIDUAL INCOME TAX (IIT)

Circular No. 59 provides that the tax authorities will conduct further research into and improve IIT regulations related to outbound investment.

Although the current IIT law contains foreign tax credit rules for foreign-sourced income earned by an individual, there is no guidance similar to the FTC rules under the CIT regime. Therefore, uncertainties remain in practice.

FURTHER DEVELOPMENT OF BUSINESS TAX (BT) POLICIES

Circular No. 59 provides that tax authorities will improve the relevant BT rules for outbound enterprises that provide services overseas.

Under current BT regulations, as long as the service provider or service recipient is located within China, the income arising from the service is subject to BT, unless an exemption applies. Exemptions are limited to a few industries such as international shipping, telecommunications and offshore service outsourcing. Thus, outbound enterprises that provide services to overseas service recipients will normally be subject to BT if it provides such services through a service provider located within China. If the foreign tax jurisdiction in which the services are provided deem the resulting income to be subject to tax there will be double taxation of such service income (*i.e.*, in both China and the foreign jurisdiction). Therefore, detailed guidelines need to be in place to avoid double taxation of such service income received by an outbound enterprise.

APPLICATION OF RELEVANT DOUBLE TAX AGREEMENTS (DTAS)

Circular No. 59 also emphasises the application of relevant DTAs that China has signed with other jurisdictions.

Tax treaties are legal agreements between countries (or, in some cases, special administrative areas such as Hong Kong and Macau) to coordinate the taxation of income. In order to avoid double taxation and promote international economic cooperation, the competent tax authorities are encouraged to better understand the needs of outbound enterprises. In particular, it is a good sign that Circular No. 59 requires the competent authorities to report to the SAT those countries or regions with which outbound enterprises wish the SAT to sign tax treaties, so that the SAT can make appropriate plans.

Outbound enterprises may be required to submit a PRC tax resident certificate to tax authorities in foreign jurisdictions when they claim eligibility for and apply to enjoy certain treaty benefits. Therefore, outbound enterprises are encouraged to proactively get more support from the Chinese tax authorities through more efficient tax registration for outbound investments, especially the issuance of China tax resident certificates so that they can be entitled to preferential treatment under relevant DTAs.

What Outbound Enterprises Should Know Regarding Other Relevant Tax Regulations

Outbound enterprises should be aware of certain tax rules and principles pertaining to tax avoidance and deferral. We have summarised below some key concepts, mainly from an income tax perspective.

CHINA TAX RESIDENT ENTERPRISE (TRE)

The TRE concept was recently established under the CIT regime and may expose certain enterprises incorporated overseas to tax within China. In brief, under certain circumstances a foreign business entity may be deemed to be a Chinese tax resident (*i.e.*, a TRE) for Chinese tax purposes. If an enterprise incorporated outside China is regarded as a China TRE, it will pay CIT based on its worldwide income derived from sources inside and outside of China. Its dividends, other income and gains payable to overseas shareholders, and, technically, the capital gain derived by an overseas shareholder from the sale of interests in the entity could be subject to China tax.

The TRE concept has a significant effect on the outbound investment of Chinese enterprises. This is particularly true when there are no actual overseas functions or operations undertaken by a foreign SPV owned by a Chinese enterprise, and the management and control of such SPV is exercised in China. Such an SPV runs the risk of being characterised as a China TRE, resulting in its worldwide income being subject to Chinese tax.

THE CONTROLLED FOREIGN CORPORATION (CFC) RULE

Generally, pursuant to the new CIT law effective 1 January 2008 and related rules (*e.g.*, Circular Guo Shui Fa [2009] No. 2 regarding implementation rules of special tax adjustment), where TREs, or TREs and Chinese individual residents, jointly control an enterprise that is established in a foreign jurisdiction in which the effective tax burden is substantially lower than (*i.e.*, less than 50 per cent of) the tax rate as stated in the CIT law (*i.e.*, a flat rate of 25 per cent in the CIT law), if the profits of such enterprise are not distributed or the profits are accumulated in an amount that exceeds reasonable operational needs of the enterprise, the portion of the aforesaid profit which is attributable to China TREs shall be added to their income in the current period, subject to certain exceptions. (The CFC rules in Circular No. 2 apply only to the CIT tax, and thus these rules apply only to businesses, not individuals.)

Outbound enterprises should be aware of the CFC rules in order to properly decide whether income derived by the enterprises outside of China will be treated as taxable income in China. For example, this could be the case when a Chinese enterprise employs a special purpose vehicle (SPV) located in a tax haven to act as a holding company where the main purpose is to "accumulate" investment profits offshore.

GENERAL ANTI-AVOIDANCE RULE (GAAR)

Pursuant to the CIT law, its DIR and the Circular Guo Shui Fa [2009] No. 2, when an enterprise enters into an arrangement without a reasonable commercial purpose and such arrangement results in a reduction of taxable gross income or taxable income, the Chinese tax authorities have the power to adjust the enterprise's income for purposes of computing the enterprise's taxes. Generally, the term "without reasonable commercial purpose" refers to transactions in which "the main purpose is a reduction, exemption, or deferral of tax payments" and it also generally shall be read in connection with the principle of "substance over form".

Therefore, outbound enterprises should be careful to ensure that there is a "reasonable commercial purpose" for the outbound transaction to avoid any challenges from the tax authorities based on the GAAR.

In light of these considerations, while outbound enterprises are encouraged to effectively utilise the tax benefits and incentives currently available with respect to outbound investment, they must bear in mind the need to navigate the relevant tax anti-avoidance rules. If triggered, these rules could result in a higher tax burden and more aggressive tax investigations and audits.

Non-Tax Regulatory Considerations for Chinese Outbound Investment

In addition to tax regulations, outbound enterprises should also pay special attention to relevant non-tax regulatory requirements in relation to the registration and approval of outbound investments, as well as the conversion and utilisation of foreign exchange for outbound investment. Below is a brief summary of the key regulations in this regard.

THE CORPORATE LAW PERSPECTIVE

According to the Administrative Measures on Outbound Investment (Order of the Ministry of Commerce [2009] No. 5 (MOC Order [2009] No. 5)), the Ministry of Commerce (MOC) and its subordinates at the provincial level are responsible for the approval, administration and supervision of outbound investment by Chinese enterprises. In addition, alteration of the outbound investment is also subject to the approval of the relevant authorities. Therefore, outbound enterprises must obtain approval of the MOC or its subordinates at the provincial level before they sign or alter any outbound investment agreements.

Moreover, MOC Order [2009] No. 5 provides that outbound enterprises shall submit true and accurate reports to the relevant authorities (*i.e.*, the MOC or its subordinates at the provincial level) with respect to the operations of the outbound investments.

In addition, the Chinese government requires special approval be obtained from it for overseas investment projects involving either (i) resource development (*e.g.*, exploitation of crude oil and mining) or (ii) using large amounts of foreign exchange (without regard to the nature of the project). These projects are subject to the examination and approval of the National Development and Reform Commission (NDRC) (some large-size projects require further review by the State Council) or its subordinates at the provincial level.

THE FOREIGN EXCHANGE LAW PERSPECTIVE

According to the *Foreign Exchange Regulations Regarding Outbound Direct Investment* (Hui Fa [2009] No. 30 (Circular Huifa No. 30)) issued by the State Administration of Foreign Exchange (SAFE), assets or equity interests generated in outbound investments must be registered or filed with the SAFE.

According to Circular Huifa No. 30, foreign exchange resulting from dividends, decreases in paid-in capital, share transfers and the liquidating of shareholdings in an overseas entity may be kept outside of China and used to establish or acquire other outbound enterprises, as long as the relevant outbound enterprise obtains approval from the relevant authorities and makes certain required filings with the SAFE. In addition, any alteration of the registered information of the outbound enterprise must also be registered with the SAFE.

Circular Huifa No. 30 also provides that when there is any material event which does not involve a change of capital (*e.g.*, a change in the long-term equity or bond investments of an outbound enterprise or guarantees provided to third parties), the outbound enterprises must notify the SAFE with respect to such material events.

In addition, pursuant to a new circular *Notice of the State Administration of Foreign Exchange on the Relevant Issues concerning the Foreign Exchange Administration of Overseas Loans Granted by Domestic Enterprises* (Hui Fa [2009] No. 24 (Circular Huifa No. 24)), a Chinese enterprise (other than a financial institution) is allowed to directly provide a loan to its wholly owned overseas subsidiary or an overseas enterprise in which the Chinese enterprise holds shares within certain approved limits, provided the other criteria set out in the Circular Huifa No. 24 are met.

Tax and Regulatory Considerations In The Country of Investment

In the case of a Chinese outbound enterprise seeking to invest or establish a business presence in a country outside China, consideration must be given to the efficient structuring of such expansion not only from a business perspective but also from tax and regulatory perspectives.

Recently, there have been a number of developments relevant to Chinese investors' outbound investment into the United States. The United States is becoming one of the more popular investment destinations for large Chinese enterprises, particularly with regard to natural resources, sales and distribution channels, advanced technologies, human resources, strategic holding company locations and global recognition. In this regard, our U.S. law firm, McDermott Will & Emery LLP, has prepared some practical tips in an appendix to this white paper regarding U.S. tax considerations. For further details, please refer to *A General Introduction to Chinese Investment in the United States*.

Summary

Circular No. 59 envisages various future improvements and enhancements being made to the tax structure in China applicable to Chinese enterprises seeking outbound investment opportunities. This includes new tax legislation and administrative guidelines.

Circular No. 59 only indicates broad areas of tax law and administration that the Chinese tax authorities plan to focus on without addressing substantive issues. However, outbound enterprises may find the circular useful as guidance with respect to tax planning, especially with regard to the application of FTCs under CIT law and the application of relevant tax treaty benefits. Also, the circular may provide outbound enterprises with a hint of what Chinese tax authorities will be focusing on in the near future and which tax compliance considerations will be especially important.

Outbound enterprises are also advised to take relevant Chinese tax anti-avoidance rules (*e.g.*, the CFC, TRE and GAAR) into consideration to avoid any tax challenges stemming from their proposed overseas structure and transactions, as well as to remain in compliance with other regulatory and foreign exchange control requirements.

Last but not least, it is imperative to have a comprehensive understanding of the legal and tax requirements of the destination country for investment. Such understanding is vital for prosperous business development from a compliance perspective as well as an advisory perspective.

For more information, please contact your regular MWE China or McDermott lawyer or any member of our integrated U.S.-China tax service team:

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