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CHINA TAX ALERT

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VAT to be excluded from calculation of income withholding tax on cross-border royalties and rents

Regulations discussed in this issue:

- Announcement concerning the CIT issues for non-residents under the VAT Pilot Program, Announcement [2013] No.9 ('Announcement 9')
- Circular of the Ministry of Finance and the State Administration of Taxation on the Issue of Levying Enterprise Income Tax on Non-resident Enterprises, Cai Shui [2008] No. 130 ('Circular 130')
- Circular on Carrying out the Pilot Collection of Value-Added Tax in Lieu of Business Tax on the Transportation Industry and some Modern Services Industries in Shanghai, Cai Shui [2011] 111 ('Circular 111')

Background

On 19 February 2013, the State Administration of Taxation (SAT) of the People's Republic of China (PRC) issued Announcement 9. The new announcement clarifies that if a non-resident enterprise derives certain China-sourced passive income that falls within the scope of the value added tax (VAT) reform pilot program, the VAT arising on such passive income is not to be included in the taxable base for calculating the corporate income tax (CIT) that should be withheld for the non-resident recipient (CIT WHT). As a result, the CIT burden for the non-resident enterprise is effectively reduced.

Announcement 9

The types of income affected by Announcement 9 are those passive income items defined in Paragraph 3 of Article 3 of the CIT Law, to the extent that they are subject to VAT under the VAT reform pilot program. Such income items mainly consist of royalties and rents. For the purposes of discussion in this Alert, we will illustrate the computation of CIT WHT for a royalty payment made by a Chinese licensee to a non-resident licensor, assuming that the royalty payment falls within the scope of the VAT reform pilot program.

A cross-border royalty payment from China to a non-resident enterprise is subject to CIT withholding at a 10 percent statutory rate, subject to tax treaty relief when relevant. The basis for calculating the CIT WHT is set out in the CIT Law and the Detailed Implementation Rules ('DIR'). Specifically, Article 19 of the CIT Law provides that CIT WHT will be calculated on the 'total income', and Article 103 of the DIR clarifies that the latter means the 'total consideration and extra charges paid to a non-resident enterprise". Whether indirect taxes should be included in the taxable base for calculating the CIT WHT thus depends on whether they are considered to form part of this 'total consideration and extra charges'.

Before the VAT reform pilot program was launched in Shanghai on 1 January 2012, business tax (BT) was the main indirect tax applied to royalties. Under the CIT system prior to the introduction of the new CIT Law in 2008, deduction for BT was allowed in calculating CIT WHT. However, Circular 130 specifically ruled that effective from 1 January 2008, no "taxes or other charges" may be deducted in determining the "total consideration and extra charges", and therefore brought BT into the taxable base for CIT WHT calculation.

As the VAT reform pilot program in 2012 replaced BT with VAT for cross-border royalties originating from the VAT pilot regions, a question arose as to whether the taxable base for CIT WHT should similarly include VAT. Article 17 of Circular 111, which guides the implementation of the VAT reform, states that for VAT withholding purposes, the price paid to a non-resident comprises VAT. It is uncertain, however, whether for CIT WHT computation, a similar approach is to be adopted. Presumably, VAT may also be covered by the term "taxes or other charges" in Circular 130 and thereby constitute a portion of the 'total income' received by the non-resident recipient.

Meanwhile, there are various arguments against including VAT as part of the 'total income' for CIT WHT calculation. First, VAT, in contrast to BT, is considered external to the "total consideration and extra charges". Furthermore, different from BT, VAT is typically a balance sheet item and not recognised in the income statement. Finally, unlike BT, VAT withheld by the Chinese payer can potentially be used as an input credit to offset its own VAT obligations. Consistent with these arguments, a 2012 internal tax circular in Beijing suggested that VAT should be excluded from the taxable base in assessing CIT WHT. However, in the absence of a national announcement from the SAT, local practices may vary among different regions.

Announcement 9 confirms that VAT may be excluded from the computation of CIT WHT. It prescribes uniform CIT WHT treatment among regions under the VAT reform pilot program and effectively ends controversy on this subject.

KPMG observations

Announcement 9 is a welcome development in the non-resident taxation area. The clarified treatment is in accordance with the generally understood principles of the VAT and CIT systems, and clears up the confusion that previously existed. Chinese taxpayers should follow the new rule in determining the amount of CIT to be withheld. Over-withholding may result in delays in seeking refunds subsequently and could cause problems for some non-resident enterprises in seeking foreign tax credits in their home jurisdictions.

The clarifications in Announcement 9 appear to lead to a relatively unfavourable treatment where BT, rather than VAT, applies to royalties; i.e., the non-resident enterprise receives license fees or rents from a Chinese taxpayer located outside a VAT reform pilot region. This relatively unfavourable treatment may persist until the VAT reform is rolled out across the entire country.

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