



China Tax for the **Auto Industry**

Tax incentives for the auto industry

1. HNTE incentives

China is increasingly transforming itself from a manufacturing powerhouse to an innovation centre. Authorities across different levels, functions and locations in China are keen to offer incentives and special tax benefits in an effort to attract investment and encourage innovation. This bodes well for the auto industry, whose executives, like many of those in other industries with competitive markets, now recognise that the path to success lies in innovation.

The High and New Technology Enterprise (HNTE) qualification is a popular incentive often accessed by auto parts manufacturing companies that grants a 15 percent preferential corporate income tax (CIT) rate to companies in China that meet the criteria. However, expanding business activities coupled with ever-changing regulations have made it more difficult for certain companies to continue to satisfy certain HNTE qualification criteria.

Personnel requirements

One of the HNTE qualification criteria requires at least 30 percent of a company's personnel to hold college or higher degrees, at least 10 percent of which must be engaged in R&D activities. Yet many auto parts companies, being typically manufacturing businesses, find this criterion challenging to meet due to the labour intensive nature of their operations and the relatively large number headcounts usually required in production facilities.

Therefore, a common arrangement adopted by companies seeking to qualify for this criterion is to have staff loan arrangements with labour agencies. Under this arrangement, workers legally employed by labour agents are loaned to the companies to provide manufacturing services. The companies then argue that the loaned workers should not be considered their employees, and therefore, should be excluded from total headcount calculations.

However, the new PRC Labour Contract Law, effective from July 2013, stipulates that the employment of labour by way of staff loan arrangements should only be applicable for temporary or auxiliary positions, and such positions should not last for more than six months. This means that workers currently loaned to a company from labour agents may need to be employed by the company as its own employees going forward, if these workers are to be employed for more than six months or for temporary or auxiliary positions. As a result, the total headcount of the company will increase and the percentage of the qualified scientific technology staff over the total headcount may drop to a level below the threshold.

In light of this development, companies should:

- Assess the possibility that the labour authority will implement the revised PRC Labour Contract strictly and require manufacturers to employ loaned staff as their own employees
- Re-consider their staffing arrangements and closely monitor headcount ratios to ensure that they satisfy the criteria for HNTE
- Consider measures that may minimise exposure, such as outsourcing labour-intensive but low-profit manufacturing processes to related party manufacturers (who are not seeking HNTE status) or splitting the company into two legal entities, with one engaged in labour-intensive and low-profit manufacturing activities and the other maintaining core value operations (e.g. R&D, marketing) and qualifying as an HNTE.

R&D expenditure requirements

Companies seeking to qualify as an HNTE must also ensure that their ratio of R&D expenditure to total sales is no less than 3 to 6 percent (depending on the total sales of the companies). This poses a challenge for companies expanding their businesses and growing their sales, which may need to keep increasing their R&D expenditure rapidly in order to satisfy the R&D expenditure requirements and maintain their HNTE status.

One option that might help reduce the total reported sales of a company and consequently help a company satisfy the R&D expenditure requirements, would be to consider selling its products to a related party trading company at a price lower than it ordinarily would to third party customers. This reduction in total sales would make it easier for the company to satisfy the R&D expenditure requirement.

Although this arrangement would mean that the portion of the profit transferred to the related party trading company will be subject to the higher standard CIT rate of 25 percent, the majority of the profit will still remain with the HNTE, subject to the lower preferential CIT rate of 15 percent. This is still preferable to the situation where the company loses its HNTE status entirely, so that all of its profits are subject to 25 percent CIT.

In implementing such an arrangement, it is important to ensure that the sales between the HNTE and the related party trading company are still conducted on an arm's-length basis. A detailed Transfer Pricing (TP) study supporting the arm's-length range of pricing charged by the HNTE to the trading company, based on the risks and functions transferred to the trading company, as well as a detailed analysis on the tax implications of the business/function transfer should be conducted.





2. Challenges from tax authorities on bonus deduction



Unlike HNTF incentives, which demand the satisfaction of numerous requirements and conditions, bonus deductions on qualified R&D expenditures are applicable on a broader basis. For instance, the bonus deduction incentive is accessible to many companies in the auto industry (e.g. not only auto parts suppliers but also OEMs). We have met with many examples of companies in the auto industry that are able to generate R&D expenditures qualified for the bonus deduction, but still remain ineligible for HNTF incentives for one reason or another (e.g. location of IP ownership, or substantial staff headcount diluting the percentage of staff with college degrees or higher qualifications).

However, although the R&D bonus deduction incentive has a broader applicability from a technical perspective, we are seeing more and more companies facing challenges and being questioned by tax authorities on their entitlement to the bonus deduction, the result of which can be damaging, adding significant additional tax costs to the company.

For instance, in practice, it is common for a tax payer to lose its ability to enjoy the bonus deduction just because it was not aware of and did not strictly follow the required procedures, such as:

- No detailed documents have been prepared to substantiate the content, budget and team members involved in the R&D project
- No detailed R&D projects are specified in the service contract for outsourced R&D activities
- No summary report showing the results and outcomes of the R&D projects are prepared
- R&D expenses are not separated by projects and types.

Further, it is worthwhile for auto companies to be aware of not just the general requirements of the bonus deduction, but also those more nuanced and specific requirements and restrictions (although some are without regulatory merit) raised by the tax authorities in different locations; these should be taken into consideration when the R&D activities are designed and implemented. For example, some tax authorities require that in order to enjoy such a bonus deduction, R&D expenses must be recognised in G&A expenses rather than as a cost of sales (which is a common account used to recognise the raw materials consumed for R&D activities).

3. Branch vs. legal entity

A common conundrum often faced by foreign auto and auto parts companies expanding their presence in China is whether to incorporate a new legal entity, or to use their existing Chinese subsidiaries to set up a new branch. Where previously foreign auto companies have almost always preferred to set up legal entities instead of branches in order to enjoy the “2+3 CIT holiday” policy, this may no longer be the case.

The “2+3 CIT holiday” was a tax incentive scheme introduced to encourage foreign investment into China, where Foreign Invested Enterprises (FIEs) were entitled to two years of exemption from CIT followed by three years of a 50 percent reduced CIT rate. However, with the phasing out of the “2+3 CIT holiday” under the new CIT regime, many foreign auto and auto parts companies are looking to streamline their legal structures in China and convert existing legal entities into branches, or set up new branches under an existing Chinese subsidiary. Unlike legal entities, no additional registered capital is required to set up a branch, and under the branch structure, tax losses can be utilised more efficiently due to the consolidated CIT filing mechanism for head office and its branches.



Nevertheless, it is still pertinent to consider some of the pitfalls of setting up a branch instead of a legal entity; branches often find it more difficult to be awarded local financial subsidies and to obtain local government approval for establishment as compared with a legal entity. In addition, uncertainties still remain with respect to whether branches are required to file CIT and value added tax (VAT) locally, and if so, how the taxes should be calculated. This is because despite the ability to file a consolidated CIT return, a portion of the total CIT is still payable to the local tax authority by an “operational branch” (manufacturing branches are very likely to be treated as operational branches) where that branch is located. For example, a Chinese company whose head office is incorporated in Shanghai has an “operational branch” in Nanjing – under consolidated CIT filing, the CIT liability will be calculated on a branch-head office consolidated basis. However, a portion of the total CIT payable under the consolidated filing is payable to the local tax authority in charge of the Nanjing branch, and how this portion is calculated is still subject to uncertainties. Although regulations stipulate that the portion of the CIT belonging to the local authority is to be calculated based on operating revenue, salaries and wages, and total assets, questions still remain as to how these factors are to be determined (e.g. whether the equipment purchased by the head office, but used by the branch, should be considered a branch asset).

Similarly, while there is no technical requirement for a manufacturing branch, which does not conclude a sales contract with and collect sales proceeds from customers directly, to file VAT returns locally, some local tax authorities may still ask for it on the basis that the branch is carrying out manufacturing activities locally, which constitutes a major part of the operation of the company as a whole. This then begs the question of how revenue should be determined for VAT purposes for branches carrying out manufacturing activities – a question that cannot be clearly answered based on current VAT regulations.

In light of the above, it is important to fully appreciate and weigh up the benefits of establishing branches over legal entities. The relevant regulations and local practices regarding CIT and VAT filing obligations must be understood in order to minimise potential challenges from the tax authorities, not only in charge of the head office, but also in charge of the branch.

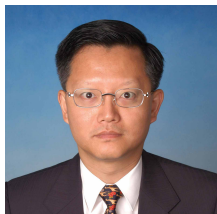


Contact us



Khoonming Ho
Partner in Charge, Tax
China and Hong Kong SAR
Tel. +86 (10) 8508 7082
khoonming.ho@kpmg.com

Northern China



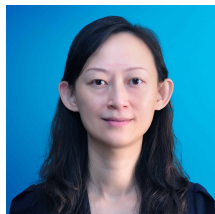
David Ling
Partner in Charge, Tax
Northern China
Tel. +86 (10) 8508 7083
david.ling@kpmg.com

Central China



William Zhang
Partner, Tax
National Auto Sector Leader
Tel. +86 (21) 2212 3415
william.zhang@kpmg.com

Southern China



Lilly Li
Partner, Tax
Tel. +86 (20) 3813 8999
lilly.li@kpmg.com

Hong Kong



Daniel Hui
Partner, Tax
Tel. +852 2685 7815
daniel.hui@kpmg.com

Transfer Pricing



Cheng Chi
Partner in Charge, Transfer
Pricing
China and Hong Kong SAR
Tel. +86 (21) 2212 3433
cheng.chi@kpmg.com

Indirect Tax



Lachlan Wolfers
Partner, Tax
Leader, Centre of Excellence,
Indirect Taxes
Tel. +852 2685 7791
lachlan.wolfers@kpmg.com

Trade & Customs



Eric Zhou
Partner, Tax
Beijing
Tel. +86 (10) 8508 7610
ec.zhou@kpmg.com

R&D



Bin Yang
Director, Tax
Leader, China R&D Tax Practice
Tel. +86 (20) 3813 8605
bin.yang@kpmg.com

Automotive Sector Leader



Andrew Thomson
Partner,
Head of Automotive,
China and Asia Pacific
Tel. +852 2143 8875
andrew.thomson@kpmg.com

Automotive Sector Leader



Michael Jiang
Partner, Corporate
Finance
Head of Automotive,
China
Tel. +86 (10) 8508 7077
michael.jiang@kpmg.com

Audit



Norbert Meyring
Partner, Audit
Tel. +86 (21) 2212 2707
robert.meyring@kpmg.com

Transactions & Restructuring



Linda Lin
Partner, Transactions &
Restructuring
Tel. +86 (21) 2212 3525
linda.lin@kpmg.com

Consulting



Leah Jin
Partner, Consulting
Tel. +86 (21) 2212 3633
leah.jin@kpmg.com

kpmg.com/cn

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

© 2014 KPMG, a Hong Kong partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. The KPMG name, logo and "cutting through complexity" are registered trademarks or trademarks of KPMG International. Printed in Hong Kong. Publication number: HK-TAX14-0002 Publication date: January 2014