Q&A: Tax Considerations for Companies with Treasury Structures in China

The liberalization of policies in China has created opportunities for many companies to implement treasury structures domestically as well as integrate China into global or regional businesses. In this Q&A dialogue, Kenny Lam from PricewaterhouseCoopers’s China Tax Management and Process Services Group addresses commonly-asked questions for businesses with global or regional treasury structures.

Q1 What are the key tax considerations a corporate should review before implementing a cross-border pooling solution?

A1 For a Chinese entity lending to its overseas affiliates, the Chinese entity would be subject to China corporate income tax of 25% and value-added tax (VAT) of 6% on interest income collected overseas with effect from 1 May 2016. In addition, foreign countries may impose withholding tax on interest income paid to the Chinese entity. In this case, an application for tax credit in China would need to be made with the local Chinese tax authorities. Furthermore, a Chinese stamp duty of 0.005% of the loan amount stated on the contract would be imposed.

For the Chinese entity borrowing from its overseas affiliates, the Chinese entity would be obliged to withhold income tax of 10% and VAT of 6%/1(1+6%) on interest income paid to overseas affiliates with effect from 1 May 2016. The same overseas affiliates may also need to apply for tax credit of the withholding income tax of 10% paid in China with their home tax authorities. Similarly, a Chinese stamp duty of 0.005% of the loan amount stated on the contract would be imposed.

Table: Key Tax Considerations for Chinese Entities

<table>
<thead>
<tr>
<th></th>
<th>Chinese entity lending to overseas affiliates</th>
<th>Chinese entity borrowing from overseas affiliates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate income tax</td>
<td>25%</td>
<td>None</td>
</tr>
<tr>
<td>Value-added tax (VAT) on interest income</td>
<td>VAT of 6% on interest income collected*</td>
<td>VAT of 6%/1(1+6%) on interest income paid*</td>
</tr>
<tr>
<td>Withholding tax (WHT)</td>
<td>Foreign countries may impose WHT on interest income paid to Chinese entity</td>
<td>Chinese entity obliged to withhold WHT of 10%, which is imposed on interest payments made to the overseas affiliate</td>
</tr>
<tr>
<td>Tax credit application</td>
<td>Application with local Chinese tax authorities if WHT imposed</td>
<td>Overseas affiliate may need to apply with home tax authorities for tax credit on WHT imposed</td>
</tr>
<tr>
<td>Stamp duty</td>
<td>0.005% of the loan amount</td>
<td>0.005% of the loan amount</td>
</tr>
</tbody>
</table>

Note: There are no differences between a renminbi (RMB) and foreign currency (FCY) cash pooling solution. *Effective 1 May 2016, business tax would be replaced by VAT thus only VAT would apply.

Q2 If we select two companies that are affiliates to be involved in the cross-border pool arrangement, would this affect our tax obligations?

A2 The tax implications as stated above would apply in this situation as local Chinese tax authorities expect related parties’ transactions to be conducted on an arm’s length basis.

Q3 In the case where a Chinese entity borrows from an overseas entity, is the Chinese entity obliged to withhold tax and VAT?

A3 As discussed above, when the Chinese entity pays interest income to its overseas affiliates; it has the obligation to withhold income tax of 10% and VAT of 6%/1(1+6%) (effective 1 May 2016).
Q4 Interest income created in cross-border and domestic cash pooling structures is now also subject to VAT. Could you please briefly share how VAT is applied?

A4 From China’s tax regulatory perspective, VAT is borne by service recipients in general unless the party responsible for VAT is explicitly defined in the commercial contract. As a brief illustration of VAT under the new VAT regime, a Chinese entity should charge RMB100 interest income plus VAT of 6% to its overseas affiliate. The Chinese entity’s interest income would still be RMB100 but the VAT of 6% collected should be available for offset against VAT paid by the Chinese entity to its vendors. Only the net VAT amount needs to be reported by the Chinese entity to the local tax authorities.

Q5 Is VAT applicable on the Entrustment Loan commission collected by the bank as services provided for arranging cash pooling for its customers?

A5 Starting from 1 May 2016, banks in China should issue VAT invoices to customers for this commission and thus customers should be able to claim a VAT credit. However, if a bank provides an overdraft facility to its customers and charges interest, the bank will not issue a VAT invoice. Instead a normal China invoice would be issued, and customers will not be able to claim VAT credit.

Q6 With regards to the new VAT rule of “unified borrowing and unified lending model”, is the related interest gain eligible for VAT exemption under a domestic cash pooling structure?

A6 Interest income arising from entrustment loans between the header company and cash pool participants in the “unified borrowing and unified lending model” of non-bank customers within the same group should be exempted from VAT if the following conditions are met: (1) the header company borrows from financial institutions or issues external corporate bonds, (2) the interest rate charged to the header company is no lower than the interest rate charged to its affiliates. As there are still uncertainties that require further clarification, for example: (1) whether financial institutions include both China and non-China financial institutions, (2) whether external corporate bonds need to be issued within China or include issuance outside of China, please contact your tax consultants for further advice.

Q7 There are differing interest rate benchmarks, between the China onshore (CNY) market and offshore (CNH) markets. Which rate/market best reflects the arms-length nature of the intercompany loan?

A7 China’s tax regulation only stipulates that related parties’ transactions should be conducted on an arm’s length basis. As such, in practice, the local Chinese tax authorities may use the leading rate of similar term announced by the People’s Bank of China as a benchmark to assess the reasonableness of the interest rate charged by the Chinese entity or overseas affiliate.

Q8 What considerations would affect the most appropriate benchmark rate?

A8 People’s Bank of China’s interest rate may be used as a benchmark by the local Chinese tax authorities when assessing the reasonableness of the interest rate charged by the Chinese entity or overseas affiliate.

Q9 In the recent announcement No. 16, 2015 on administrating transfer pricing, how does this affect the borrowing and lending rate to be applied?

A9 Circular16 further strengthens the arm’s length principle of related parties’ transactions and allows the local Chinese tax authorities to make tax adjustments of up to 10 years. In brief, Circular16 reiterates that outbound payments to overseas related parties should follow the arm’s length principle, and that the Chinese payer may be required by local Chinese tax authorities to file relevant documentation with the in-charge tax bureau to support the arm’s length basis of the interest rate charged. Additionally, payments to an overseas related party which bear no substantial operation or activities and does not undertake functions or bear risks may not be deductible for China corporate income tax purposes.