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China's Tax Authority Issues New Circular to Regulate Payment to Overseas Affiliates

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On July 29, 2014, the State Administration of Taxation (SAT) of the People's Republic of China (PRC or China) released The Notice Regarding the Launch of Tax Anti-Avoidance Investigations on Remittance of Substantial Amounts of Service Fees and Royalty Payments (Circular 146), which requires tax authorities at all levels to conduct investigations on substantial payments of service fees and royalties made by domestic enterprises to their overseas affiliates from 2004 to 2013. Further to Circular 146, on March 18, 2015, the SAT released The Notice Regarding Certain Corporate Income Tax Matters on Outbound Payments to Overseas Affiliates (Circular 16), with its interpretation (Interpretation) released by SAT the next day on SAT's official website.

Circular 16 emphasized that all payments made by domestic enterprises to their overseas affiliates must comply with the arm's length principle and any payment failing to follow such principle may be subject to special tax adjustment by tax authorities within 10 years of such payment. Circular 16 also provides tax authorities the authority and administrative discretion to require domestic enterprises to provide relevant documentation upon request, including the contracts or agreements between the domestic enterprises and their overseas affiliates, and relevant supporting documents that can verify the transactions and prove that the transactions comply with the arm's length principle. The purpose of Circular 16 and the Interpretation are to crack down on any disguised forms of transfer of capital outside China under cover as payments of services fees, which will substantially impact the tax income of the Chinese government.

Furthermore, Circular 16 specifies the following four types of payments (**Unqualified Payments**) to be made by a PRC domestic company to its overseas affiliates that would not be allowed by the tax authorities to be deducted from the taxable income for the calculation of the enterprise income tax (EIT) of the domestic company.

1. Payment without Corresponding Services/Functions

If a domestic company makes a payment to an overseas affiliate, but such overseas affiliate does not perform any functions nor does it bear any risks, or such overseas affiliate has no substantial operations, such payment will not be deductible from the taxable income of the domestic company.

2. Payment for Unbeneficial Services

Based on Circular 16 and the Interpretation, domestic enterprises receiving services from their overseas affiliates must obtain direct or indirect economic benefits in consideration for the paid services fees. Any payments for non-beneficial services are not deductible for EIT purposes. The following are examples of such non-beneficial services:

- Services that are not related to the functions of and the risks borne by the domestic enterprise or operation of the domestic enterprise
- Services such as control, management and supervision of the domestic company carried out by the overseas affiliate for protecting the investment interests of direct or indirect investors in the domestic enterprise;
- Services that have already been purchased from a third party or have been undertaken by the domestic enterprise itself
- Services where the domestic enterprise obtains additional benefits solely for being part of a corporate group, and it has not received any specific services from the overseas related party within the same corporate group
- Services that have been compensated through payments to other affiliates.

3. Payment of Royalty for Intangible Assets where the Overseas Affiliates has made no contribution to the Value Enhancement/Creation of such Intangible Assets

In case of license of intangible assets, Circular 16 provides that royalties paid to an overseas affiliate that only owns the legal right to the intangible assets but having no contribution in creating its value, not in compliance with the arm's length principle, is not deductible for EIT purposes. In determining whether the royalties are deductible, the key factor to consider is whether and how much contribution the overseas affiliate has made to the value of the intangible assets. Based on the Interpretation, each party's functions performed in the transaction, assets employed and risks assumed in the intangible assets development, enhancement, maintenance, protection, application and promotion should be considered to decide the contributions made by each party to the intangible assets, which is the basis to confirm the economic benefits that each party is entitled to in the transaction and to determine how much royalties should be paid to the overseas affiliate.

4. Payment of Royalty in Compensation for Incidental Benefits arising from financing or listing activities

Circular 16 provides that where an overseas holding company or a financing company is established offshore for the main purpose of financing or listing, royalties paid to an overseas affiliate in compensation for incidental benefits arising from such financing or listing activities are not deductible for EIT purposes. This Article applies to domestic enterprises whose parent entities or affiliate entities are listed abroad with their main businesses in the PRC. Any payment made by such domestic enterprises to its offshore

financing or listing entities merely due to the overseas entities' names, brand and other information listed on publicity materials would not be deductible for the calculation of EIT of the domestic company.

It is possible that the SAT and its local counterparts may launch a tax investigation for the purpose of enforcing Circular 16. Multinational corporations (**MNCs**) doing business in the PRC should pay special attention to the requirements of Circular 16, and conduct an internal review to identify if any previous or existing transactions fall under the scope of Unqualified Payments under Circular 16. MNCs should be prepared for any investigations by the competent tax authorities and prepare sufficient and credible documentation to justify such payments to overseas affiliates.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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