

LEHMANBROWN

律華會計師事務所

International Accountants

insights@lehmanbrown

Breakthrough for Trading Companies operating in FTZ's
Update - Income Tax for Real Estate Developers
Individual Income Tax of Severance Payments
Tightening up on the Individual Income Tax Net

Breakthrough for Trading Companies operating in FTZ's

The Administration of Industry and Commerce recently issued a circular providing foreign investment enterprises ("FIE") more flexibility in setting up branches outside free trade zones ("FTZ").

Previously FIE's already registered in FTZ's were not allowed to establish branches or representative offices outside the FTZ. Trading companies previously were restricted to acting simply as invoicing agents or pass-through entities. The business scope of such representative offices is restricted to conducting business liaison activities for its head office. Furthermore, the new rules state that the representative offices located outside the FTZ cannot enjoy the tax incentives available to its head office within the FTZ. The FTZ FIE can now branch out to other locations in China to conduct liaison activities.

A tax planning opportunity also exists for those foreign investors that have representative offices and FTZ companies. By converting the foreign representative office to an office of the FTZ company, investors can save the tax that are currently imposed on the foreign representative offices.

稅

services@lehmanbrown

Professional Services

Financial Accounting

增值税

"Zeng Zhi Shui"

(Value Added Tax)

营业税

"Ying Ye Shui"

Clarification of Tax Issues for Foreign-Invested Real Estate Developers

The State Administration of Taxation (SAT) has issued a circular to clarify certain income tax issues for foreign-invested real estate developers ("Developers").

Previously, developers had to pay income tax based on the estimated profit and then settle the final tax liability when the final piece of property is transferred to the purchaser (especially important with large-scale apartment buildings), and the sale is recognized.

Under the new Circular, developers are required to continue to pay the income tax on the estimated profit on a quarterly basis, but the final settlement will be made when the relevant government authority issues the Property Project Qualification Certificate, or when the right of use of the property is transferred, or when the title of the property is transferred (whichever is earlier). In effect, the final tax settlement will be accelerated.

The Circular also provides rules for recognizing revenue under different modes of sale, e.g. lump-sum payment, pre-payment, payment by installments or property swap or through mortgage loans, etc., and stresses the matching principle between revenue and cost. This principle should also apply when the property is allocated among shareholders as return of investment. The developer is required to aggregate all the expenses and costs of the invested project and then allocate them among shareholders based on the shareholders agreement. Shareholders shall settle their own tax accordingly upon sale of real estate.

Expenses for auxiliary projects, incurred after sale of properties such as road-building and tree-planting, may be accrued based on a pre-determined percentage subject to the approval by the tax authority. Also, developers are

- required to combine rental income and other operating income together to provide a total income amount. Depreciation of the underlying property and related costs are then matched against this income and can be deducted for tax purposes. However, the depreciation will reduce the basis of the property and therefore if later the leased property is sold, the depreciation expenses will be recaptured.

In the past, there has been some uncertainties about the tax treatment in the case where a foreign company sells the properties on behalf of the developer. The Circular clarifies that if a foreign company acquires the real property from the Developer and then on-sells it to a final customer, the foreign company will be subject to tax on the amount of gain on the sale. If the foreign company only acts on the developer's behalf to sell the property, the Developer will be subject to tax based on the final sales price (as required by Guoshuifa (1999) No. 242.)

(Business Tax)

消费税

"Xiao Fei Shui"

(Consumption Tax)

所得税

"Suo De Shui"

(Income Tax)

New Individual Tax Treatment of Severance Payments

The State Administration of Taxation recently issued a circular to reduce the individual income tax ("IIT") burden of severance payments. Severance payment amounts not exceeding 300% of the last year's average salary (for that location) can be exempted from IIT calculations. The severance payment portion exceeding that exemption limit is, however, subject to the tax rate mitigation scheme.

However, as the average salary of a city varies from locality to locality, it is important for both human resources professionals and taxpayers to be aware of the local variances in applying the exemption right granted by the above circular.

Tightening up of the Individual Income Tax Net

The State Administration of Taxation ("SAT") issued two circulars relating to Individual Income Tax ("IIT"), which have an effect of tightening up the IIT net. Firstly, the circular laid down restrictions for IIT exemptions on home leave allowances and expenses. Prior to this circular expatriates in China had to rely on the exemption clause in a 1997 circular to exclude their home leave allowances or reimbursement of home leave expenses incurred for overseas trips from the IIT calculations.

The new circular, however, clarifies the situation allowing for only two trips per annum; and these trips must be to the expatriate employee's home country or that of his/her spouse or parents, if different.

Furthermore, according to another circular, the tax authorities at all levels were instructed to make a concerted effort to tighten and prioritize tax collection procedures for selected high income earners in view of the rising income disparity prevailing within the country. Among the targeted industries are telecommunications, finance, brokerage, insurance, real estate, transportation, petrochemical, hi-tech, professional consulting and businesses conducted by foreign investment enterprises, foreign enterprises, and representative offices of foreign companies.

From an individual taxpayer's perspective, sole proprietors, marketing and managerial personnel, contractors, directors, accountants, lawyers, auditors, valuers and designers, etc., have been the identified targets. In other words, these individuals, especially those working in the aforesaid industries, will be closely monitored and may be tracked under special files.

To pre-empt the upcoming queries from the tax authorities, foreign investors in China should ensure that proper remuneration policies together with relevant supporting documentation are in place to defend their current IIT reporting and filing.

"Providing an alternative in China"

insights@lehmanbrown provides updates of the latest taxation and accounting regulations in the People's Republic of China. It is designed to provide you with interesting and informative information to assist in your dealings with China or any China-related issues that you may encounter. If you do not wish to receive this newsletter, we have provided an unsubscribe facility below.

LehmanBrown also provides a monthly newsletter *Peeling the Onion* which investigates certain topical issues affecting businesses in China, particularly for those companies and individuals with operations in the PRC, or looking to establish a presence in-country.



Recent editions include:

- ▶ Due Diligence in China
- ▶ Transfer Pricing Strategies in China
- ▶ Business Fraud in China
- ▶ Corporate Valuations in China
- ▶ Crisis Management in China
- ▶ China's Changing Tax Environment
- ▶ Internal Controls in China
- ▶ Establishing an SME in China

▶ Managing Your China Business Under SARS

▶ Treasury Management in China

▶ Banking in China

▶ Mergers and Acquisitions in China

▶ Bridging the Accounting Standards Gap in China

▶ The Changing Role of CFOs and Accountants in China

▶ Transfer Pricing Investigations...When not if!

You can subscribe to these newsletters through our website: www.lehmanbrown.com

Or you can visit the full LehmanBrown library at: www.lehmanbrown.com/library.htm

©

2002 LehmanBrown. This newsletter is intended to be used for news purposes only. It should not be taken as comprehensive financial advice, and LehmanBrown will not be held responsible for any such reliance on its contents.