

New tax levies - Urban Construction & Maintenance Tax and Education Surcharge for foreign-related companies and individuals

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On 18th October 2010, the State Council issued Guofa [2010] No. 35 entitled *"Notice regarding unification of Urban Construction & Maintenance Tax ("UCMT") and Education Surcharge ("ES") for all domestic companies and foreign-related companies and individuals."* Circular 35 states that UCMT and ES shall be equally applied to foreign invested companies, foreign companies and foreign individuals in China ("collectively referred to as FIEs") effective from 1st December 2010.

The key points of Circular 35 are as follows:

- FIEs will be subject to the UCMT and ES effective from **1st December 2010**;
- All regulations and rules with respect to UCMT and ES issued by relevant Chinese tax authorities also apply to FIEs; and
- Any regulations which conflict with Circular 35 will be abolished simultaneously.

By the virtue of the new circular, from 1st December 2010 onward, the UCMT and ES shall be imposed on the FIEs which will undoubtedly increase the tax burden to the FIEs. The announcement demonstrates Chinese tax authorities' determination to establish a level playing field for all domestic companies and FIEs in the PRC and further equalize the tax environment after the unification of Corporate Income Tax, Real State Tax and Vehicle and Vessel Tax.

Introduction of the UCMT and ES

UCMT and ES were introduced in 1985 and 1986 respectively. They are local surcharges imposed at a prescribed percentage of turnover tax i.e. Value-Added Tax ("VAT"), Business Tax ("BT") and Consumption Tax ("CT"). The current ES rate is 3% while the UCMT rate is 7%, 5% and 1% respectively depending on the localities of the taxpayers. The 7% is applied to the taxpayers located in the urban areas, 5% is applied for the taxpayers located in the county and towns and 1% for taxpayers in rural areas. The UCMT& ES payable shall be calculated as follows:

$$\text{UCMT \& ES payable} = \text{VAT/BT/CT payable} \times (\text{applicable UCMT+ES rate})$$

These two local charges shall be filed and paid during the same filing period as the payment of turnover taxes is made.

Impact on the foreign investors

- With the introduction of Circular 35, UCMT and ES will undoubtedly become part of new tax cost to all foreign invested companies, foreign companies and foreign individuals in China. Although the amount of tax surcharges may be immaterial compared to the turnover tax paid, it is still suggested for affected companies to take such additional tax levy into consideration. The impact on a VAT FIE (assuming

that a FIE located in Beijing urban area and is subject to 7% UCMT) could be illustrated by the following table:

Unit: RMB

	1	2
A	Revenue subject to VAT at 17%	100
B	Cost	60
C	Gross Profit	40
D	Output VAT (A1x17%)	17
E	Input VAT (B1x17%)	10.2
F	VAT payable (C1-D1)	6.8
G	UCMT&ES (E1x(7%+3%))	0.68
H	Increased percentage of tax burden on gross profit (G/C) *	1.7%

*Please note that the increased percentage varies with different levels of revenue.

Similarly, the impact on a BT-able FIE (assuming that a FIE located in Beijing urban area and is subject to 7% UCMT) could be illustrated by the following table:

Unit: RMB

	1	2
A	Revenue subject to BT at 5%	100
B	BT payable (A1x5%)	5
C	UCMT&ES (B1x(7%+3%))	0.5
D	Increased percentage of tax burden (C/A)	0.5%

Given the taxability of UCMT and ES would affect the cost structure, and hence bottom line profit of a FIE, one option that can be considered is, with reference to the above estimation of the increased percentage of tax burden, to adjust the selling price so as to pass down the costs to the buyer.

- Circular 35 stipulates that UCMT and ES shall be applied from 1st December 2010, therefore the first tax filling and payment for the two newly added charges will be conducted during the January 2011 filing period, i.e before 15th January 2010.

For the case where taxpayers perform turnover tax filling e.g. VAT, BT and CT on a quarterly basis (typically for a representative office) , taxpayers should be allowed to segregate turnover tax paid in December alone for UCMT & ES calculation purpose since the effective date of the new levy starts only since December 1, 2010. Nevertheless, the filing software may not be able to accommodate this special scenario and may cause some complication. Owing to the lack of implementation rules on filing and settlement process on state level, the FIEs are encouraged to contact their in-charge tax bureaus for

local practice beforehand. Meanwhile, we will closely monitor and keep you posted of any further development in this regard.