

## **State Administration of Taxation Clarifies Several Implementation Issues Regarding Corporate Income Tax**

[12nd April, 2010 Issue 7]

On 22nd February 2010, the China State Administration of Taxation (SAT) issued circular Guoshuihan [2010] No.79 (Circular 79) to clarify several issues concerning the implementation of the Corporate Income Tax (CIT) law.

### **Highlights of Circular 79**

#### **1. Recognition of Rental Income**

According to Article 19 of the Detailed Implementation Rules (DIR) of CIT Law, rental income refers to the income derived by an enterprise from the provision of the right to use fixed assets, packaging materials, or other tangible assets, and should be recognized as income on the rental payment due date as agreed with the lessee in the lease contracts. In case the rental period as stipulated in the lease contract cross calendar years and the rental is paid in lump sum in advance, based on Article 9 of the Detailed Implementation Rules, the rental income may be amortized over the relevant years within the leasing period. The above also applies to non-resident enterprises, which have establishments in China, and which report and pay CIT on an actual profit basis.

#### **2. Recognition of Income Derived from Debt Restructuring**

Income derived from debt restructuring should be recognised on the effective date of the debt restructuring agreement.

#### **3. Recognition of Capital Gain**

Income derived from an equity transfer should be recognised when the equity transfer agreement has come into effect and the procedures of equity transfer have been completed. The taxable income is the gross income derived from the equity transfer minus the investment cost of the disposed shares. The invested enterprise's retained earning attributable to the disposed shares cannot be deducted from the sales proceeds for CIT purposes.

#### **4. Recognition of Dividend Income**

Dividend income should be recognised on the day when the resolution is made by the invested enterprise to distribute dividend or to convert after-tax profit into shares. In case an invested enterprise's capital surplus, arising from a capital premium is converted into shares, such increased shares shall not be recognised as dividend income for the shareholders, and accordingly, the cost base of such long-term investment shall not be adjusted for CIT calculation purpose for the investors.

#### **5. Recognition of tax base for fixed assets**

In case a fixed asset has been put into use while the full-amount invoice has not been obtained due to that the construction payment has not being settled, the enterprise can temporarily use the amount as set out in the construction contract as the tax base of the fixed assets and depreciate the fixed assets accordingly. The tax base should be adjusted after the full-amount invoice has been obtained, however, the adjustment must be made within 12 months after the fixed asset is put into use.

#### 6. Deductibility of Costs and Expenses Corresponding to Tax-Exempt Income

Based on Article 27 and Article 28 of the Detailed Implementation Rules, unless otherwise prescribed by the relevant rules, an enterprise's costs and expenses in connection with the tax-exempt incomes are deductible for CIT purpose.

#### 7. Pre-Operating Expenses

The year when an enterprise starts to operate should be the first year when the enterprise starts to calculate gain and loss. The expenses incurred before the enterprise starts to operate should not be recognized as loss in the current year. In contrast, Article 9 of Guoshuihan [2009] No.98 (Circular 98) should be followed. Based on Circular 98, an enterprise may elect either to take a one-off deduction in the year when it commences operation, or to recognize the pre-operating expenses as long-term assets and amortize over no less than three years. Once the election is done, it cannot be changed.

#### 8. Calculation of Deductible Entertainment Expenses

For enterprises engaged in equity investment (including headquarters of group companies and venture capital investment companies), dividend incomes derived from invested enterprises and capital gains derived from equity transfers should be taken into account when calculating the deductible entertainment expenses, which, based on Article 43 of the DIR, should be the lower of 60% of the actually incurred amount and 0.5% of the sales (business) income of the current year.

#### **LehmanBrown's Observation**

Circular 79 clarifies several issues relating to the implementation of the Corporate Income Tax law just before the annual CIT reconciliation deadline. Foreign invested enterprises are suggested to review their income recognition policies and the treatment of certain expenses accordingly.

A big change raised by Circular 79 is that, in an equity transfer transaction, the retained earnings attributable to the disposed shares are no longer allowed to be deducted from the sales proceeds in arriving at the capital gains for CIT purpose.

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