



JONES DAY
COMMENTARY

CHINA'S THIN CAPITALIZATION RULE

On September 19, 2008, the Ministry of Finance and the State Administration of Taxation issued the Notice Concerning Taxation Policies for the Standards for Pre-Tax Deduction of Interest Payments Made to Related Parties, Cai Shui (2008) No. 121 (the "Notice"). The Notice provides guidance for the implementation of the thin capitalization rule introduced by the new Corporate Income Tax Law, which came into effect on January 1, 2008.

ACTUAL INTEREST PAYMENTS

According to the Notice, an enterprise may deduct interest actually paid to related parties within the permitted debt-to-equity ratio. It appears that the deduction should be on an actual payment basis. Accrued but unpaid related-party interest expenses are not deductible. It is not clear how this rule will interact with the withholding tax rule. According to Article 37 of the Corporate Income Tax Law, the borrower is obligated to withhold tax when interest is paid or due and payable to a nonresident enterprise. According to Article 105 of the Implementation Rules of the Corporate Income Tax

Law, "due and payable" means the amount of interest payable that should be accounted for by the taxpayer on an accrual basis. For this reason, there is a risk that a borrower would need to withhold and pay the withholding tax on the accrued interest payable to a related party while no tax deduction is permitted.

DEBT-TO-EQUITY RATIO

The Notice provides for a related-party debt-to-equity ratio of 5:1 for financial enterprises and 2:1 for other enterprises. The related-party debt includes not only direct loans from a related party but also a back-to-back loan where a related party provides, through an unrelated party, an unrelated-party loan guaranteed by a related party or secured by the assets of a related party, and other investment in the nature of a debt indirectly obtained from a related party. The interest on related-party debt exceeding the permitted amount will not be deductible when computing taxable income for Corporate Income Tax purposes in the current year or future periods.

In computing the debt-to-equity ratio, only the debt and equity from a related party are considered, and unrelated-party debt is excluded. For example, if a company with 100 equity borrows 100 from an unrelated bank and then takes a parent loan of 200, the related-party debt-to-equity ratio is 2:1, while the enterprise's debt-to-equity ratio would be 3:1. In such a situation, the thin capitalization rule does not disallow an interest deduction on the parent loan. It is not clear whether the equity is the amount of registered capital or the net equity. As the thin capitalization concept is based on the notion of the ability to borrow on the market, the net equity (i.e., registered capital and capital reserves adjusted for accumulated retained earnings or losses) would make sense.

EXCEPTIONS

The Notice provides two exceptions. First, if an enterprise can prove that the related-party loan complies with the arm's-length principle, the enterprise can deduct interest expenses on the related-party loan in spite of the related-party debt-to-equity ratio exceeding the standard. Second, if the actual tax rate of the borrowing enterprise is not higher than that of a related-party lender within China, the borrowing enterprise can deduct the actual expense of interest payments to the related party. This exception is not applicable to cross-border transactions.

DEBT-TO-EQUITY RATIO IN RELATION TO "TOTAL INVESTMENT TO REGISTERED CAPITAL" RATIO

China foreign-investment regulations provide for "total investment to registered capital" ratios. "Registered capital" is

actual paid-in capital, and "total investment" is registered capital plus debts. Theoretically, the debts may include all debts of an enterprise. In practice, only foreign debt is considered in computing the "total investment to registered capital" ratio and enforced through the foreign-debt registration process. An enterprise must register its foreign debt under China foreign-exchange regulations. A foreign-invested enterprise cannot register its foreign debt if the accumulated amount of the mid- to long-term (more than one year) foreign loans and the balance of short-term loans (one year or less) exceeds the difference between the total investment and the registered capital of the enterprise. Without proper registration, a foreign-invested enterprise will not be able to convert the loan proceeds into RMB and remit the funds for payment of interest and principal.

The "total investment to registered capital" ratio is tested on an enterprise basis. For foreign-debt registration purposes, all foreign debt of the foreign-invested enterprise, including both related and unrelated debt, will be considered. Under the thin capitalization rule, only related-party debt, including both foreign and domestic debt, will be considered. As a result, if all the debt financing of a wholly foreign-owned enterprise is from its foreign parent company, the foreign-invested enterprise can use as the basis for calculation only the loan amount that is the smaller under either the "total investment to registered capital" ratio under the foreign-investment regulations or the debt-to-equity ratio under the thin capitalization rule. The following table compares the ratios under both foreign-investment regulations and the thin capitalization rule that are applicable to nonfinancial foreign-invested enterprises.

Registered capital (USD in millions)	Foreign-investment regulations		Thin capitalization rule
	Total investment to registered capital	Approximate equivalent of debt to equity	Debt to equity
Less than 2.1	1.43:1	0.43:1	2:1
2.1 to less than 5	2:1	1:1	2:1
5 to less than 12	2.5:1	1.5:1	2:1
12 and more	3:1	2:1	2:1
30 to less than 100 (investment holding co. only)		4:1	2:1 (?)
100 or more (investment holding co. only)		6:1	2:1 (?)

A foreign-investment holding company is a special vehicle that can be used by a foreign company to hold its China investments. Foreign-investment regulations allow higher leverage for foreign-investment holding companies than for other nonfinancial enterprises. The thin capitalization rule does not provide any special debt-to-equity ratio for foreign-investment holding companies. Presumably, the 2:1 ratio is also applicable to foreign-investment holding companies. Given the higher leverage permitted under foreign-investment regulations, it may be easy for foreign-investment holding companies to avail themselves of the arm's-length principle exception to the debt-to-equity ratio.

TREATMENT OF INTEREST RECEIVED

The thin capitalization rule does not recharacterize interest received by related-party lenders. Where an interest expense is not deductible for the borrower, such interest is still treated as interest income to the lender subject to income tax.

LAWYER CONTACT

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