



JONES DAY
COMMENTARY

CHINA IMPOSES BUSINESS TAX ON FOREIGN SERVICES

On November 10, 2008, the China State Council issued the amended Provisional Regulations of the PRC on Business Tax ("BT Regulations"). On December 15, 2008, the Ministry of Finance and the State Administration of Taxation ("SAT") issued the Implementation Rules of the Provisional Regulations of the PRC on Business Tax ("BT Rules"). Both the BT Regulations and the BT Rules will come into effect on January 1, 2009. The BT Rules reinterpret the scope of taxable services and impose business tax on foreign services.

NEW DEFINITION OF SERVICES WITHIN THE TERRITORY OF CHINA

Business tax is imposed on the provision of services and the transfer of intangibles and immovable properties within the territory of China. The business tax rate for most services is five percent of gross service fees. Previously, the interpretation was that the service provider would be liable for business tax only if the taxable services were performed within China. As such, if a foreign company provided services to a Chinese company and such services were performed

outside China, such services were generally not subject to business tax in China. Typically, those services included design, engineering, consulting, and technical services performed outside China.

Article 4 of the BT Rules now provides that "the territory within the PRC" means "the unit or individual who provides or accepts taxable services is in the territory of China." According to this new interpretation, if services are provided to an enterprise, a nonbusiness organization, or an individual in China, the service provider will be liable for business tax on or after January 1, 2009, regardless of where the services are performed. Accordingly, foreign services to a Chinese company would be subject to China business tax.

INTEREST AND LEASE PAYMENTS

Finance and leasing services should be taxable services under the BT Regulations. A 1997 tax circular, Guo Shui Fa (1997) No. 35, issued by the SAT, provided for business tax exemption on interest income and leasing income on movable property leases for foreign

lenders and lessors. In 2006, SAT tax circular Guo Shui Fa (2006) No. 62 invalidated various tax circulars including Guo Shui Fa (1997) No. 35. It was not clear then whether foreign lenders/lessors would be liable for business tax because it was not clear whether the foreign lenders and lessors were considered to be providing services in China. Now, under the BT Rules, the place of services is no longer the only factor to determine whether the services are subject to business tax. If the borrowers and lessees are in China, it seems that the interest and leasing payment from China should be subject to China business tax. Business tax on interest will apply to not only financial institutions but also foreign companies that make loans to their China subsidiaries and affiliates.

IMPACT ON FOREIGN SERVICE PROVIDERS

The new interpretation of the BT Regulations will increase the cost of foreign services to Chinese companies. Under the BT Regulations, a service provider is liable for business tax on service fees. However, the service provider can shift the cost of business tax to the service recipient by contract. A contract provision that requires a service fee payment net of all China taxes is commonly used to shift such tax cost. Such contract provision will not release the foreign service provider from its obligation to pay business tax if the Chinese company fails to pay necessary tax on the service provider's behalf. The obligation of tax compliance and indemnity for noncompliance should be included in the contract to protect foreign service providers. Furthermore, the amount of business tax borne by the Chinese company will be reclassified as a service fee subject to business tax. As such, the service fee will be grossed up in computing business tax liability.

It is not clear how the tax authorities will implement the BT Rules and whether some exceptions will be available. Many issues need to be clarified by the future tax regulations or practice.

ENFORCEMENT IN CONJUNCTION WITH FOREIGN EXCHANGE PAYMENT CONTROL

On November 25, 2008, the State Administration of Foreign Exchange and the State Administration of Taxation jointly issued a circular concerning tax certificates on foreign exchange remittance for payment for services and other items, Hui Fa (2008) No. 64, which will come into effect on January 1, 2009. The circular requires a certificate issued by the tax authorities for foreign currency remittance of any single payment in the amount of more than US\$30,000 for various services and transfers. The new BT Rules will be enforced in conjunction with the implementation of the new foreign exchange rule. For service payments of more than US\$30,000 to a foreign service provider, the Chinese payer will need to withhold and pay business tax and income tax, if any, and obtain a tax clearance certificate from the tax authorities. Without such tax certificate, the bank in China will neither sell foreign exchange to the payer nor process the fund transfer.

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