JONES DAY

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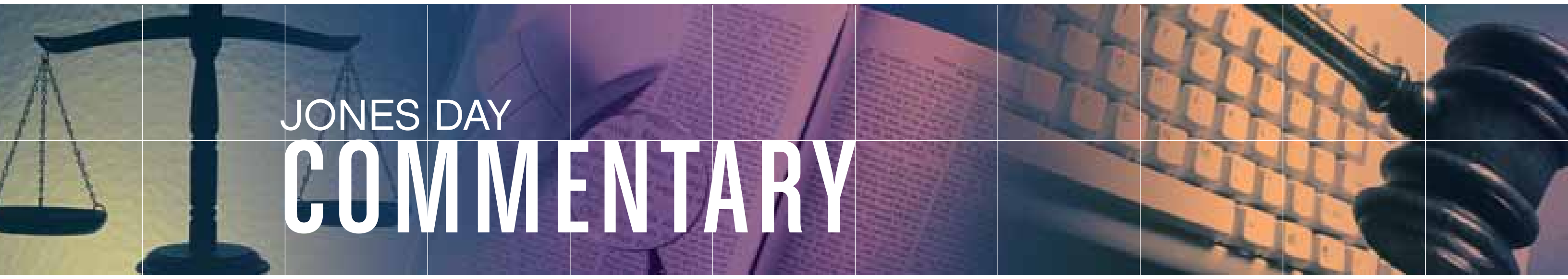

CHINA CLARIFIES RULE ON FOREIGN TAX CREDITS

According to China Corporate Income Tax Law ("CIT Law"), a China resident enterprise is subject to China Corporate Income Tax ("CIT") on its worldwide income. A nonresident enterprise is liable for CIT on its income derived from China. If a nonresident enterprise has an establishment or place of business in China, the enterprise is subject to CIT on its income from China and overseas that is effectively connected to the establishment or place of business in China. A resident enterprise may claim foreign tax credit for foreign income tax paid on its taxable income from sources outside China. A nonresident enterprise may claim foreign tax credit for foreign income tax paid on its taxable income from sources outside China that is effectively connected with the establishment or place of business of such nonresident enterprise within China.

On December 25, 2009, the Ministry of Finance and the State Administration of Taxation issued the Notice on the Issues Concerning Foreign Tax Credits, Cai Shui [2009] No. 125 (the "Notice"). The Notice provides guidelines for claiming foreign tax credits by China resident enterprises and the establishment of nonresident enterprises in China. The Notice is retroactively effective to January 1, 2008.

CREDIT BY COUNTRY

According to the CIT Law and its implementation rules, the amount of foreign tax credit cannot exceed CIT otherwise payable on the income calculated in accordance with the CIT Law. Such credit limitation is calculated by country (region) and not by income category; the calculation formula is as follows:

> Tax credit limitation = Total tax payable on income derived from both within and outside China as calculated in accordance with China tax law x taxable income from the particular foreign country (region) ÷ total taxable income derived from both within and outside China.

The Notice clarifies that foreign source income, creditable tax, and credit limitation with respect to each country or region must be separately computed. In computing taxable income, common expenses must be reasonably allocated between China-source income and foreign-source income (by country). The losses of a branch in a foreign country cannot offset income derived from China or income from other foreign countries; such losses can be used to offset income from the same country in the current year and subsequent five years.

CREDITABLE TAX

Creditable tax must be in the nature of corporate income tax and the actual amount paid by an enterprise in accordance with the tax laws and regulations of foreign countries or regions. Creditable tax does not include:

- Tax paid by an enterprise or collected by a foreign country or region by mistake.
- Tax in excess of the limitation as provided by applicable tax treaties.
- Interest, late payment charges, and penalties for underpayment or late payment of tax.
- Tax paid and subsequently refunded.
- Foreign tax on income that is exempted from CIT under the CIT Law.
- Tax that has been deducted in computing taxable income.

However, if an enterprise is granted a tax exemption or reduction by a foreign country and if the applicable tax treaty provides that the amount of tax exempted or reduced is deemed to have been paid, then the deem-paid tax is creditable and the enterprise may claim a tax sparing credit.

INDIRECT CREDIT

If a resident enterprise operates abroad through a subsidiary, the income earned by the subsidiary normally is not taxable in China until the profits of the subsidiary are distributed to the resident enterprise. Upon the dividend declaration, the resident enterprise may claim foreign tax credit for the income tax paid by the subsidiary and attributable to the dividends. In order to qualify for the indirect foreign tax credit, a resident enterprise must directly or indirectly own at least 20 percent of equity interest in a foreign enterprise.

The Notice clarifies that an enterprise may claim indirect foreign tax credit for income tax paid by three tiers of foreign subsidiaries. In computing the direct or indirect ownership of 20 percent:

- For a first-tier foreign subsidiary, the resident enterprise must directly own 20 percent or more of the subsidiary.
- For a second-tier foreign subsidiary, one first-tier subsidiary must directly own 20 percent or more of the second-tier subsidiary, and the resident enterprise must directly or indirectly own 20 percent or more of the second-tier subsidiary.
- For a third-tier foreign subsidiary, one second-tier subsidiary must directly own 20 percent or more of the third-tier subsidiary, and the resident enterprise must directly or indirectly own 20 percent or more of the third-tier subsidiary.

Foreign tax paid and attributable to the dividend received by a resident enterprise should be computed from the lowest tier of creditable foreign subsidiary. The following formula is used to allocate a portion of foreign income taxes paid by a foreign subsidiary to the dividend distribution:

> Tax allocated to dividend = (Tax paid by a foreign company + tax paid by its subsidiary allocated to dividend received) x dividend paid to parent company ÷ the after-tax profits of the foreign company.

The formula basically requires that a foreign income tax pool and an after-tax profit pool are computed and maintained for each foreign subsidiary. When the subsidiary distributes dividends, foreign income tax will be allocated to dividend distribution and deducted from the tax pool. As a foreign subsidiary may not distribute all earnings each year, it will be important for taxpayers to obtain and maintain evidence to prove the actual payment of foreign income taxes and detailed computation of allocation of such tax to dividend distribution.

SIMPLIFIED METHODS

A taxpayer may adopt a simplified method to claim 12.5 percent of taxable income derived from a foreign country as foreign tax credit upon the approval of the tax authority in charge. To adopt the simplified method, the following conditions must be met:

- The taxpayer can produce evidence issued by the foreign tax authority for the payment of tax; however, the amount of tax paid cannot be accurately identified for objective reasons.
- The effective tax rate at an income source country is no less than 12.5 percent. This means that the foreign tax credit will be the lesser of 12.5 percent and the amount shown on the tax payment evidence.

The Notice has identified some countries whose statutory tax rate is obviously higher than that of China. These countries include Argentina, Bangladesh, Burundi, Cameroon, Cuba, France, Japan, Jordan, Kuwait, Laos, Morocco, Pakistan, Syria, the United States, and Zambia. Where income derived from these countries and the effective tax rate is higher than China's statutory rate, 25 percent, the following formula can be used:

Foreign tax credit = Taxable income from foreign source x 25%.

UNCLARITY

China's foreign tax credit rule requires that the foreign tax credit limitation be computed on a per-country basis. It is not clear how to compute such per-country limitation where the dividends received from a first-tier foreign subsidiary include dividends derived from lower-tier subsidiaries in different countries.

For example, suppose a resident enterprise receives an RMB100 dividend from a first-tier foreign subsidiary A in Country X. A has a total RMB300 of after-tax profit comprising RMB100 from its operations in Country X and RMB200 dividends paid by second-tier subsidiaries B (in Country Y) and C (in Country Z).

It is not clear whether the RMB100 dividend will be treated as originating all from Country X or from all three countries and, if the latter, how to allocate the dividend to each country.

LAWYER CONTACT

For further information, please contact your principal Firm representative or the lawyer listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

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