



JONES DAY
COMMENTARY

CHINA UNIFIES CITY MAINTENANCE AND CONSTRUCTION TAX AND EDUCATION SURCHARGE FOR DOMESTIC AND FOREIGN INVESTED ENTERPRISES

On October 18, 2010, the State Council issued the Notice on Unification of City Maintenance and Construction Tax and Education Surcharge for Domestic Enterprises, Foreign Invested Enterprises, and Foreign Individuals, Guo Fa (2010) No. 35. On and after December 1, 2010, City Maintenance and Construction Tax and Education Surcharge will apply to foreign enterprises, foreign invested enterprises, and foreign individuals.

In China, City Maintenance and Construction Tax is levied on transactions subject to VAT, Business Tax, and Consumption Tax. The tax base is the amount of VAT, Business Tax, and Consumption Tax paid. Tax rates are 7 percent for taxpayers in urban districts of cities, 5 percent for taxpayers in towns, and 1 percent for taxpayers in other areas. Similar to City Maintenance and Construction Tax, Education Surcharge is also levied on transactions subject to VAT, Business Tax, and Consumption Tax. The tax rate is 3 percent of the amount of VAT, Business Tax, and

Consumption Tax paid. Currently, foreign enterprises, foreign invested enterprises, and foreign individuals are exempt from City Maintenance Tax and Education Surcharge; such taxes only apply to domestic enterprises and Chinese nationals. This is soon to change, however.

This tax unification will increase the tax burden on operations and investment in China by foreign companies. Many foreign invested enterprises operate in the areas where 7 percent City Maintenance and Construction Tax applies. For those enterprises, the combined rate for City Maintenance and Construction Tax and Education Surcharge should be 10 percent of VAT, Business Tax, and Consumption Tax paid. Such taxes will affect all foreign invested enterprises because they pay either VAT or Business Tax or both.

VAT payers who pay VAT at the regular rate of 17 percent of the sales price will need to pay an additional 1.7 percent of the sales price as City Maintenance

and Construction Tax and Education Surcharge on or after December 1, 2010. This 1.7 percent tax is not recoverable, although it can be deducted when computing Corporate Income Tax. Business Tax payers who pay Business Tax at 5 percent of the gross service fee will need to pay additional 0.5 percent of gross service fee as City Maintenance and Construction Tax and Education Surcharge on or after December 1, 2010.

It is not completely clear how City Maintenance and Construction Tax and Education Surcharge will apply to non-resident enterprises that provide services outside China to service recipients inside of China or that receive interest or royalties not connected with a permanent establishment in China. Those nonresident enterprises generally are subject to Business Tax on the foreign services, interest, and royalties, typically 5 percent of gross service fees, interest, and royalties. Because they are Business Tax payers, it appears that they should be subject to City Maintenance and Construction Tax and Education Surcharge. If so, it is likely that the City Maintenance and Construction Tax rate where the withholding agent (*i.e.*, the paying person in China) is

located will apply. In this scenario, for example, a foreign licensor would need to pay a total of China taxes at 15.5 percent of gross royalties (Business Tax—5 percent, Corporate Income Tax—10 percent, City Maintenance and Construction Tax—0.35 percent, and Education Surcharge—0.15 percent) compared to the current rate of 15 percent. The Chinese tax authorities may issue an implementation circular to clarify the matter. City Maintenance and Construction Tax and Education Surcharge do not apply to dividends.

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