

China Tax & Investment News

China clarifies corporate income tax treatment of service fees paid by subsidiaries to parent company

Deductibility of inter-company service payments among Chinese entities clarified

Executive summary

The State Administration of Taxation (SAT) recently issued a tax circular, namely Guoshuifa [2008] No. 86 (hereinafter referred to as "Circular 86") laying down the basic principles and the mechanism for treatment of service fees paid by a Chinese subsidiary to its parent company in Mainland China for Corporate Income Tax (CIT) purposes.

Strictly speaking, Circular 86 does not bring with it any new concepts, but rather a reiteration of the arm's length principle. The circular is worded to specifically cover a situation where a parent company in Mainland China provides service to its Chinese subsidiaries. In a nutshell, Circular 86 requires the parent to charge the subsidiaries a service fee based on a reasonable profit similar to an arm's length transaction between unrelated parties. The circular also requires the execution of service contracts between the parent and the subsidiaries ready to be submitted to the tax authorities as supporting evidence.

The circular does not mention whether similar principles and procedures apply to the parent and its subsidiaries under a cross border situation. Unlike an old tax circular governing the provision of service by a Chinese Holding Company to its investee companies in Mainland China which required a specific profit mark up percentage on actual expenditure, Circular 86 does not mention what the mark up should be.

This issue of China Tax & Investment News (the "News") describes the basic principles stipulated in Circular 86 and suggests approaches that, we believe, should be taken by company executives.

Inter-company service fee deduction principles

One of the key features in the new Corporate Income Tax Law (CITL) and its Implementation Regulations (CITLIR) effective on 1 January 2008 is a renewed focus on inter-company transactions. Most of the clauses in chapter 6 of the CITL and the CITLIR (dealing with special tax adjustments) are geared towards ensuring that related companies transact businesses on an arm's length basis.

On inter-company services, the CITL maintains an old stance apparently inherited from its pre-2008 versions and specifically provides for a disallowance of inter-company "management fees". The term "management fee" is not further defined in the CITL but we understand that the tax authorities normally interpret it as a charge without specific service and benefits received by the payer. To avoid potential issues with the Chinese tax authorities, it is advised to consider using a term more appropriate than "management fee" in situations where specific services are provided among related companies.

The CITL and the CITLIR also for the first time include specific clauses on cost sharing in situations where related parties jointly develop or jointly purchase intangible assets; or jointly provide or receive services. Such costs can be shared among related parties provided a cost sharing agreement is executed that allocates joint costs on an arm's length basis to match the expected benefits receivable by each party.

Circular 86, on the other hand, deals with service fees paid by a Chinese subsidiary to its parent within Mainland China. The circular describes the following principles and procedures governing the tax deduction for service fees in this particular situation:

1. The parent company should treat the inter-company services in the same manner as ordinary service transactions with unrelated third parties and charge the subsidiary on an arm's length basis.
2. The parent company should enter into agreement (s) with the subsidiary specifying the scope of services to be provided, the fee calculation method, the amount of fees to be charged, etc.

The parent company should pay Business Tax (BT) for the abovementioned service fees, and the subsidiary can deduct the same amounts as costs for CIT purpose.

3. If the parent company provides services of similar nature to different subsidiaries, the parent company may choose to enter into separate agreement (s) with subsidiaries for each type of service. Alternatively, the parent company may enter into a master "service sharing agreement" with all relevant subsidiaries. One thing is clear, however, that a mark up is expected on the actual expenditure incurred. The mark up needs to be determined on an arm's length basis regardless of whether the subsidiaries are profitable, at loss or enjoying tax holidays.

(N.B. How the taxation treatment of "service sharing agreement" may differ from the "costs sharing agreement" laid down in the CITL is not further elaborated in Circular 86. In the CITL, costs sharing agreement is defined to cover situations where related parties jointly develop or jointly purchase intangible assets; or jointly provide or receive services.

The fact that the circular specifically departs from the term "costs sharing agreement" and instead uses a new but undefined term of "service sharing agreement" may mean the requirement for a profit mark up may not apply to the "cost sharing arrangement".)

4. Notwithstanding, management fees paid by subsidiaries to the parent company are still not deductible for CIT purpose.

(N.B. We understand that the SAT interprets “management fees” as a pure allocation of overhead expenses without specific benefit received by the payer of the fees. Where specific benefits can be identified, company executives should always avoid using the terms “management fees” or “management services” in the inter-company service agreements.)

5. A subsidiary has to provide its in-charge tax authority with agreement(s) and other required documents to substantiate the deduction of service fee paid to its parent company.

How about cross border services?

It appears that the SAT only lays down the deduction criteria for service fees paid by a subsidiary to its parent company within Mainland China but does not mention the tax treatment of cross border transactions of similar nature among related parties. It remains uncertain whether Circular 86 can be taken as an authority to justify deductibility of service fees paid to an overseas parent company or related parties if a Chinese subsidiary can fulfill all the above basic principles.

Suggested approaches

Taxpayers in Mainland China wishing to secure deductibility of service fees paid to their Chinese parent companies should ensure that the transactions are supported by agreements describing the service scope, basis of fee charge and the amount so charged in detail. A reasonable mark up is expected in pricing the service fees, and the parent companies must have paid the relevant BT on the services fees. In order to arrive at a reasonable and justifiable margin, companies may need to analyze functions and risks surrounding the relevant transactions and substantiate the transfer pricing with proper documentation.

Last but not least, in case of doubt, companies should seek professional advice and services.



Contact us

Beijing office:

► Corporate Tax partners

Alan Lan
Tel: +86 10 5815 3389
alan.lan@cn.ey.com

Andrew Choy
Tel: +86 10 5815 3230
andrew.choy@cn.ey.com

Andy Chen
Tel: +86 10 5815 3381
andy.chen@cn.ey.com

Gregory Buteyn (US Desk)
Tel: +86 10 5815 3394
gregory.buteyn@cn.ey.com

Henry Chan
Tel: +86 10 5815 3397
henry.chan@cn.ey.com

Joseph Lee
Tel: +86 10 5815 3383
joseph.lee@cn.ey.com

Lucy Wang
Tel: +86 10 5815 3809
lucy-c.wang@cn.ey.com

Martin Ngai
Tel: +86 10 5815 3231
martin.ngai@cn.ey.com

Si-Si Xiang
Tel: +86 10 5815 2822
si-si.xiang@cn.ey.com

► Transfer Pricing partners

Jessica Tien
Tel: +86 10 5815 2806
jessica.tien@cn.ey.com

Joanne Su
Tel: +86 10 5815 3380
joanne.su@cn.ey.com

Lynn Wang
Tel: +86 10 5815 3993
lynn.wang@cn.ey.com

Guangzhou office:

► Corporate Tax partners

Enoch Chan
Tel: +86 20 2881 2738
enoch-yt.chan@cn.ey.com

Rio Chan
Tel: +86 20 2881 2878
rio.chan@cn.ey.com

Hong Kong office:

► China corporate Tax partners

Clement Yuen
Tel: +852 2629 3355
clement.yuen@hk.ey.com

David Chan
Tel: +852 2629 3228
david.chan@hk.ey.com

Loretta Shuen
Tel: +852 2629 3778
loretta.shuen@hk.ey.com

► Transfer Pricing partners

Catherine Tse
Tel: +852 2629 3091
catherine-vw.tse@hk.ey.com

Patrick Cheung
Tel: +852 2846 9905
patrick.cheung@hk.ey.com

Shanghai office:

► Corporate Tax partners

Alfred Shum
Tel: +86 21 2228 2298
alfred.shum@cn.ey.com

Audrie Xia
Tel: +86 21 2228 2886
audrie.xia@cn.ey.com

Bill Seto
Tel: +86 21 2228 2138
bill.seto@cn.ey.com

Brian-Joseph Foley (TARAS)
Tel: +86 21 2228 2069
brian-joseph.foley@cn.ey.com

Carrie Tang
Tel: +86 21 2228 2116
carrie.tang@cn.ey.com

Chris Finnerty (US Desk)
Tel: +86 21 2228 3005
chris-j.finnerty@cn.ey.com

Derek Chow
Tel: +86 21 2228 3009
derek.chow@cn.ey.com

Genqiang Gao
Tel: +86 21 2228 2105
genqiang.gao@cn.ey.com

Ivan Chan
Tel: +86 21 2228 2888
ivan.chan@cn.ey.com

Jean-Bernard Caumont
(Continental Western Europe Desk)
Tel: +86 21 2228 2669
jean-bernard.caumont@cn.ey.com

Michael Lin
Tel: +86 21 2228 3007
michael-cs.lin@cn.ey.com

Patricia Xia
Tel: +86 21 2228 2878
patricia.xia@cn.ey.com

Robert Smith
(Customs & International Trade)
Tel: +86 21 2228 2328
robert.smith@cn.ey.com

Sarah Chan
Tel: +86 21 2228 2327
sarah-kw.chan@cn.ey.com

Stephen Lee
Tel: +86 21 2228 2880
stephen.lee@cn.ey.com

Titus von dem Bongart (German Desk)
Tel: +86 21 2228 2884
titus.bongart@cn.ey.com

Vickie Tan
Tel: +86 21 2228 2648
vickie.tan@cn.ey.com

Walter Tong
Tel: +86 21 2228 2186
walter.tong@cn.ey.com

► Transfer Pricing partners

Curt Kinsky
Tel: +86 21 2228 3188
curt.kinsky@cn.ey.com

Kenji Kasahara
Tel: +86 21 2228 2624
kenji.kasahara@cn.ey.com

Philip Anderson
Tel: +86 21 2228 2269
philip.anderson@cn.ey.com

Shenzhen office:

► Corporate Tax partners

David Chiu
Tel: +86 755 2502 8180
david.chiu@cn.ey.com

Mak Ho Sing
Tel: +86 755 2502 8289
ho-sing.mak@cn.ey.com

► Transfer Pricing partner

David Chiu
Tel: +86 755 2502 8180
david.chiu@cn.ey.com

Tianjin office:

► Corporate Tax partner

Alan Lan
Tel: +86 22 5819 3566
alan.lan@cn.ey.com

Ernst & Young

Assurance | Tax | Transactions | Advisory

About Ernst & Young

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 130,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve potential.

For more information, please visit www.ey.com.

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients.

About Ernst & Young's Tax Services in China

Ernst & Young's 930 tax professionals in China provide you with deep technical knowledge, both global and local, combined with practical, commercial and industry experience. Our talented people, consistent methodologies and unwavering commitment to quality service help you to build the strong compliance and reporting foundations and sustainable tax strategies that help your business achieve its ambitions. It's how Ernst & Young makes a difference.

© 2008 Ernst & Young (China) Advisory Limited.

All Rights Reserved.

This publication contains information in summary form and is therefore intended for general guidance only. It is not intended to be a substitute for detailed research or the exercise of professional judgment. Neither Ernst & Young (China) Advisory Limited nor any other member of the global Ernst & Young organization can accept any responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. On any specific matter, reference should be made to the appropriate advisor.

The News is preliminary and should not be used for making final decisions. Comments on News are welcome and can be submitted by sending a reply e-mail message to china.services@cn.ey.com.

www.ey.com/china