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New Measures for Foreign Invested Leasing Companies

**By: Kevin Ng, Tax Partner – Beijing
Sunny Xu, Senior Tax Consultant - Beijing**

In line with China's WTO commitment, the government is now reviewing and revising its current laws and regulations for various industries in order to provide a transparent and fair legal environment for foreign investors doing business in China. As part of the process, the Ministry of Foreign Trade and Economic Cooperation ("MOFTEC") issued the long awaited *Tentative Administrative Measures on Approving Foreign Invested Leasing Companies* (Order No. 3 [2001] by MOFTEC, referred to as the *Measures*) to regulate foreign invested leasing companies and to promote the development of the leasing industry, especially financial leasing business. The *Measures* are effective from September 1, 2001.

Background

In China, financial leasing is a recent development. Under the existing practice, there are two main types of financial leasing companies.

- One is a non-banking financial leasing organization, which is established with the approval of and administered by the People's Bank of China ("PBOC"). Foreign investors are not allowed to engage in this type of financial leasing company.
- The other is a foreign invested joint venture financial leasing company established with the approval of MOFTEC. It is this type of financial leasing company that is now possible through the newly promulgated measures. There are about 40 such financial leasing companies established in China. Foreign invested financial leasing companies fall under the "restricted type B" category in the Foreign Investment Guidance Catalogue, therefore they are subject to specific approvals through MOFTEC in order for foreign investors to participate in financial leasing business in China.

Thus far, MOFTEC has only relied on an internal circular to grant permission for foreign invested financial leasing companies. The issuance of the *Measures* changes the approval process to allow for much greater certainty in the process of approving a financial leasing business in China.

The Measures

The new *Measures* makes public the requirements and procedures for a foreign leasing company and provide clarification on the requirements and business scope of a general leasing company. According to the *Measures*, leasing companies include those engaged in the financial leasing business and other leasing business. Foreign investors can undertake leasing business by setting up discrete legal entities, i.e., equity joint ventures and cooperative joint ventures. The leasing company takes the form of a Limited Liability Company. The *Measures* also set forth conditions for foreign invested leasing companies.

Requirements on Investors

A foreign investor investing in a financial leasing company should have no less than US\$400 million in total assets and more than 5 years of experience in the financial leasing industry. The total assets of its Chinese partner should be at least RMB400 million and the registered capital of a financial leasing company must be equivalent to at least US\$20 million.

For a non-financial leasing company, the foreign investor should have at least US\$50 million in total assets, with over 3 years of experience in the leasing industry. The total assets of its Chinese partner should be at least RMB100 million and registered capital of a company engaged in other non-financial leasing business is US\$5 million. For both types, the input of the Chinese partner should account for at least 20% of the total registered capital.

Business Scope

Further, the *Measures* define a specific business scope for financial leasing companies and non-financial leasing companies. Compared to their wholly domestic counterparts¹, joint venture financial leasing companies approved by MOFTEC have a much narrower business scope.

Pursuant to *Article 12* of the *Measures*, joint venture financial leasing companies can only engage in the following:

- financing leasing businesses in Chinese or foreign currency on advanced or applicable equipments for production, telecommunication, medical, scientific research, testing, engineering, transportation (including aircrafts, motor vehicles and vessels) etc., such as direct leasing, sub-leasing, sale and leaseback, assignment leasing, leverage leasing and co-leasing
- with the specification of the lessee, purchasing goods and the related technologies for leasing purpose
- selling and handling of leased goods and products

¹ According to Order 4 issued by the People's Bank of China ("PBOC") in June 2000, domestic financial leasing company is allowed to engage in the following:

- operating leasing
- accepting lease funds entrusted by legal persons or organizations
- accepting lease guarantee fund from a leasing party
- providing working capital loans to a lessee of leased property
- investing in securities and investing in the shareholding of financial organizations
- issuing bonds with the approval of PBOC
- borrowing money from financial organizations
- borrowing foreign exchange
- inter-bank lending & borrowing business
- other business approved by the PBOC

- consultation and guarantee on leasing
- other business approved by MOFTEC

According to *Article 14* of the *Measures*, the joint venture non-financial leasing companies can engage in:

- operating leasing of advanced or applicable equipment
- selling and handling the remaining value of depreciated leased goods and products
- other business approved by MOFTEC

Summary

Based on the *Measures*, a foreign investor can rely on this official and public set of requirements to get MOFTEC approval for a general leasing or a financial leasing company. However, there are restrictions to industries that may be financed, such as automobile leasing, which as a specially controlled area, is not permitted as a financial leasing item. However, all financing will be permitted once China joins the WTO. The issuance of the *Measures* should allow for greater foreign participation in both the general and financial leasing industries. The *Measures* also specify documents required for the establishment of a foreign invested leasing company and their business scope. If foreign invested financial leasing company would like to provide other financing services beyond the scope prescribed in the *Measures*, the company has to obtain approval from MOFTEC for the intended service scope. It is anticipated that more regulations will be released in the near future to eliminate the limitations and restrictions in the financial leasing industry and other areas with China admission to WTO.

China Opens Venture Capital Business to Foreign Investors

By: Patrick Su, Tax Manager – Beijing
Lily Tang, Senior Tax Consultant - Beijing

Background

Participation in venture capital business in China was limited to the Chinese. However, with the issuance of the provisional regulations, *Provisional Regulations on Establishment of Foreign Invested Venture Capital Investment Company* (Order No. 4 [2001]) by the Ministry of Foreign Trade and Economic Cooperation, Ministry of Science and Technology and State Administration of Industry and Commerce; foreigners can now participate in venture capital activity within China through the establishment of either a Wholly Foreign Owned Enterprise (WFOE), an Equity Joint Venture (EJV) or a Contractual Joint Venture (CJV). Effective September 1, 2001, regulations were passed to encourage foreign entities to invest in high-tech businesses in China.

Conditions to Establish a Foreign-invested Venture Capital Company

Registered Capital

Certain conditions and qualifications must be met for both Chinese and foreign investors. For venture capital enterprises that are WFOEs, total investment must be a minimum of US\$20 million, total worldwide assets under the management of the foreign investor for the past 3 years must be at least US\$100 million and of these funds, at least US\$50 million must have

been reinvested in the venture capital business. For foreign invested venture capital businesses that take the form of an EJV or CJV, foreign investment must be no less than 25% of the total investment in the JV.

There are also conditions for Chinese partners in foreign invested venture capital enterprises. For instance, one of the Chinese partners must invest at least US\$5 million, and its total net assets must be at least RMB1 billion. There are other conditions too in professional experience and the source of investment fund for both Chinese and foreign partners.

Business Scope

This regulation also outlines the business scope of foreign invested venture capital enterprise, which not only includes venture capital investment in high-tech businesses and other approved businesses, but also management consulting for the invested enterprises and other activities subject to approval by relevant authorities. For investment areas, while foreign invested venture capital enterprises enjoy a much broader selection than typical FIEs in China, previous foreign investment industry limitations such as military activities, certain activities in the medical and mining industries and other sensitive areas typically restricted by the government, will still operate to limit investment options. Other rules on distribution of investment returns, share transfer and buybacks, as well as application and approval procedures are also set out in this provision.

Summary

The new regulation opens the door to foreign venture capital investment as part of the government's planned to establish a capital market that supports Chinese entities with emphasis on the high-tech sector. This is the first and a significant step for China to attract investment funds from foreign venture firms. It is hoped that the government will further establish a legal framework to enable foreign investors to tap into the Chinese market through mergers, acquisitions, capital financing, etc. so that the local companies may receive the needed capital to expand.

IIT Exemption for Lump-sum Compensation Associated with Termination of Employment Contract

***By: Kevin Ng, Partner – Beijing
April Liao, Manager – Beijing***

Enterprises which streamline their work force because of corporate restructuring or for other reasons, will be pleased to know that there is a new tax circular issued by the SAT on the tax treatment of lump sum termination payments. This new circular, effective October 1, 2001, clarifies and increases the amount that can be paid on a tax free basis.

Background

Over the last two years, the SAT has issued two circulars on the individual income tax (IIT) treatment of lump-sum compensation paid to terminated staff. According to the Notice (Guoshuifa [1999] No. 178), such compensation is treated as a lump-sum salary payment but for IIT tax calculation purposes, it can be spread over a period of time. The ability to spread the payment for IIT tax calculation purposes means that the payment can be taxed at a lower tax rate than if the tax were computed on the lump sum basis. The period over which the

lump-sum payment can be spread is determined by the number of years of service by the terminated employee. The maximum number of years used for the spread-over is 12 years.

On May 8, 2000, the SAT issued another Notice (Guoshuifa [2000] No. 077) to clarify the IIT treatment of the lump-sum termination compensation received by terminated staff of State Owned Enterprises. According to this circular, if such compensation is less than three times the average annual income of the local employee of the preceding year, it is exempt from IIT; otherwise, the full compensation is subject to IIT according to Notice 178. The average annual salary of the local employee is determined by the local statistics bureau.

Calculation Examples

Assuming an employee received a lump sum severance pay of RMB 150,000 on August 1st, 2001; the IIT on the payment is borne by the employee and the annual average income of the local employee of the preceding year is RMB10,000

Example I: For an employee working for the enterprise for 5 years

The monthly amount which should be reported for IIT = $(\text{RMB}150,000 - \text{RMB}10,000 \times 3) / 5 = \text{RMB}24,000$

The total IIT payable = $[(\text{RMB}24,000 - \text{RMB}800) \times 25\% - \text{RMB}1,375] \times 5 = \text{RMB}22,125$

The employer should withhold RMB22,125 at the date of payment and report and pay the amount by September 7th, 2001.

Example II: For an employee working for the enterprise for 15 years

The monthly amount which should be reported for IIT = $(\text{RMB}150,000 - \text{RMB}10,000 \times 3) / 12 = \text{RMB}10,000$

The total IIT payable = $[(\text{RMB}10,000 - \text{RMB}800) \times 20\% - \text{RMB}375] \times 12 = \text{RMB}17,580$

The employer should withhold RMB17,580 at the date of payment and report and pay the amount by September 7th, 2001.

Points to Note

The employer is obligated to withhold the total IIT payable at the time of payment and remit the monies to the tax office before the 7th day of the following month. The withholding, however, is based upon the net taxable amount.

Another important point to note is that this new circular does not apply to expatriate employees.

As the new circular is effective from October 1, 2001, any lump-sum compensation paid prior to this effective date but which have not been reported for IIT purposes should be handled based upon the new circular.

Summary of the New Circular

The SAT recently issued a new circular (Cai Shui [2001] No. 157) to further clarify the IIT liability associated with lump-sum payments made to individuals due to the termination of the employment contract. The principal changes under the new Notice can be summarized as follows:

1. Extension to new taxpayers: the scope of the exemption is extended from state owned enterprises to all enterprises and units in China; including those employed by Foreign Investment Enterprises.
2. Increase of tax exempt income: in addition to the lump-sum compensation, living allowances and other subsidies could be exempt from IIT if the total of such allowances together with the lump-sum compensation is less than three times of the average income of the local employee of the preceding year; and
3. Change of the tax base: previously, if the lump-sum compensation is less than three times of the average income of the local employee of the preceding year, it would be exempt from IIT; otherwise, the entire amount is subject to IIT according to the Notice Guoshuifa [1999] No.178. The new circular stipulates that only the excess amount is subject to IIT.

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The National Knowledge Management Office – Tax

Chief Knowledge Officer (based in Hong Kong) : Yvonne Law

Tel: (852) 2852 1667

Fax: (852) 2541 8019

E-mail: yvolaw@deloitte.com.hk

Beijing

Alan Tsoi, Partner

Tel: (86 10) 6528 1599

Fax: (86 10) 6528 1598

E-mail: alatsoi@deloitte.com.hk

Shanghai

Nancy Marsh, Partner

Tel: (86 21) 6393 6292

Fax: (86 21) 6393 6290

E-mail: nanmarsh@deloitte.com.hk

Guangzhou

Desmond Yeung, Partner

Tel: (86 20) 8387 8555

Fax: (86 20) 8387 0199

E-mail: desyeung@deloitte.com.hk

Tianjin

Kevin Ng, Partner

Tel: (86 22) 2332 1671

Fax: (86 22) 2332 2840

E-mail: kevng@deloitte.com.hk

Knowledge Management Manager:

Annette Wong

Tel: (852) 2852 6622

Fax: (852) 2541 8019

E-mail: annwong@deloitte.com.hk

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