tax notes international

Volume 54, Number 13 ■ June 29, 2009

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Reprinted from *Tax Notes Int'l*, June 29, 2009, p. 1123

taxanalysts®

FEATURED PERSPECTIVES

Preventing Excessive Debt: China's Developing Thin Capitalization Regime

by Matthew McKee

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China recently introduced rules against thin capitalization into its tax laws, via the Enterprise Income Tax Law (EITL). Regulations have been introduced that add further depth to the basic framework established by the EITL. This article evaluates the new Chinese thin capitalization regime. In doing this, it will draw a comparison with Australia's equivalent regime, which is regarded as one of the most detailed and comprehensive thin capitalization regimes in the world.

Why Prevent Thin Capitalization?

Tax policymakers have long struggled with the challenge of balancing the need to curb tax avoidance with the desire to encourage both inbound and outbound investment. In light of the incidence of countries lowering their corporate tax rates to attract foreign direct investment, the OECD and high-taxing nations have long expressed concerns about the harmful effects of such tax competition.[1] In particular, the concern is that if unchecked, tax competition has the capacity to:

> distort trade and investment flows, cause undesirable shifts in the tax burden, impose constraints on governments' fiscal choices, increase compliance costs to taxpayers, and undermine the fairness and integrity of tax systems.[2]

One method that has been adopted to prevent the leakage of revenue to low-tax jurisdictions has been limiting the deductibility of debt expenses through rules against thin capitalization. On a general level, a company is said to be thinly capitalized when it has a disproportionately high level of debt in contrast to its equity. Such thin capitalization may enable a company to deduct an excessive amount of its debt expenses. The particular concern is that companies can shift debt expenses from low-taxing jurisdictions to high-taxing jurisdictions to reduce the level of taxable income in the latter, even though the relevant debt expenses generate income in the low-tax jurisdiction. This results in a higher level of taxable income in the low-tax jurisdiction and a lower level of taxable income in the high-tax jurisdiction, which leads to a reduction in the company's overall tax burden. This is compounded by the withholding tax on interest payments to nonresident entities, which is generally lower than the withholding tax on dividends.

The Australian Regime

In accordance with section 820-5 of the Income Tax Assessment Act 1997 (Cth), Australia's thin capitalization rules apply to three types of entities:[3]

- an Australian entity that carries on a business in a foreign country at or through a permanent establishment or through an entity that it controls (an outward investing entity);
- an Australian entity that is controlled by a foreign resident (an inward investing entity); and
- a foreign investor having investments in Australia (an inward investing entity).

[1] OECD, *Harmful Tax Competition: An Emerging Global Issue* (1998).

[2] Joann M. Weiner and Hugh J. Ault, ''The OECD's Report on Harmful Tax Competition,'' *National Tax Journal* 51(3) (Sept. 1998), pp. 601-608.

[3] Income Tax Assessment Act 1997 (Cth), section 820-5.

Division 820 makes a distinction between outward and inward investing entities and between authorized deposit-taking institutions (ADIs) under the Banking Act 1959 (Cth) and non-ADIs. Regarding non-ADI entities, Division 820 also makes a further distinction between general entities and financial entities.

The thin capitalization rules apply differently to ADIs. In recognition that such entities may need to engage in regular borrowing, the question of whether the entity is thinly capitalized is determined by whether the entity's capital is less than the prescribed level, whereas for non-ADIs the question is whether the entity's debt is higher than the prescribed level.

Subdivision 820A contains several threshold exceptions to determine whether the division applies. The three critical threshold exceptions are that the rules do not apply:

- to an entity that has operations solely in Australia;[4]
- if the total debt deductions for the entity and its associated entities are less than $250,000;[5] and
- to an outward investing entity when 90 percent or more of the value of the combined Australian and foreign assets of the entity or its associated entities are Australian assets.[6]

Regarding inward investing and outward investing entities that are non-ADIs, the rules operate so that a comparison needs to be made between the adjusted average debt of the entity and the maximum allowable debt stipulated under the rules.[7] Debt deductions are disallowed to the extent to which the adjusted average debt exceeds the maximum allowable debt.

Regarding outward investing entities, the maximum allowable debt is the greatest of the following:[8]

- the safe harbor debt amount — for a general entity, this is effectively 75 percent of the average value of the entity's Australian assets, and for a financial entity this is from 75 percent to 95 percent, depending on certain specified circumstances;[9]
- the arm's-length debt amount — effectively the amount of debt an independent party carrying on the entity's Australian operations would have incurred to undertake those operations;[10] or
- the worldwide gearing debt amount — effectively 120 percent of the gearing ratio of the entity's worldwide group.[11]

For non-ADI inward investing entities, the maximum allowable debt is the higher of the safe harbor debt amount or the arm's-length debt amount.[12]

China's Regime

China's thin capitalization rules are contained in several Chinese tax laws and regulations. Article 46 of the EITL prohibits the deduction of interest payments to a related party when the debt-to-equity ratio of the enterprise exceeds the prescribed standards. Those standards, in accordance with article 119 of the Regulations on the Implementation of the Enterprise Income Tax Law of the People's Republic of China, were issued by the Ministry of Finance and the State Administration of Taxation in the Notice on the Tax Deductibility of Interest Expense Paid to Related Parties (Caishui [2008] No. 121), which provides two prescribed debt-to-equity ratios; for financial entities the acceptable limit is 5 to 1, and for nonfinancial enterprises the acceptable limit is 2 to 1.

Under article 85 of the Implementation Measures of Special Tax Adjustments (Provisional) the related-party debt-to-equity ratio is defined as the ''portion of the debt investment received [by the entity] from all its related parties ('related-party debt investment') to the equity investment ('equity investment')''; importantly, related-party debt investment includes ''debt investment guaranteed by related parties in any form.''[13] The amount of the related-party debt investment and the equity investment are determined by the monthly average in a given year.[14] Article 89 of the measures appears[15] to make a provision for the allowance of a deduction if the debt-to-equity ratio is exceeded when the taxpayer can demonstrate that the transaction is otherwise consistent with arm's-length principles.[16]

Generally, China's thin capitalization regime is far less detailed and less comprehensive than Australia's. One significant point of difference between China's and Australia's thin capitalization rules is that China's regime is only targeted toward related-party debt. The problem is that there is a growing recognition that

[4]*Id.*, section 820-30.

[5]*Id.*, section 820-35.

[6]*Id.*, section 820-37.

[7]*Id.*, section 820-85.

[8]*Id.*, section 820-90.

[9]*Id.*, section 820-95.

[10]*Id.*, section 820-105.

[11]*Id.*, section 820-110.

[12]*Id.*, section 820-190.

[13]Implementation Measures of Special Tax Adjustments (Provisional), article 85.

[14]*Id.* at article 86.

[15]Article 89 does not explicitly establish such a right. However, it is implicit in the article that such a right exists. Further, neither the EITL nor the EITL Regulations explicitly create such a right.

[16]*Supra* note 13 at article 89.

overall excessive debt allocation provides an opportunity for tax minimization. This is an area that can legitimately be exploited by multinational companies in reducing their tax burden in China. A point of similarity is that article 89 of the measures appears to operate in a similar fashion to the arm's-length debt amount test in Division 820 of the ITAA 97. However, China's rules do not provide an exception when the entity's debt-to-equity ratio is lower than the ratio of the entity's worldwide group.

The implementation of the Chinese rules is still in its early stages, and the unanswered question at this stage will be the extent to which the SAT is aggressive in enforcing the rules. In the past, the SAT has not been overly aggressive in ensuring that taxpayers comply with China's international taxation rules, particularly regarding the PE rules that have been widely abused. However, the SAT has recently been displaying a stricter approach to tax compliance. Accordingly, while the law itself is substantially in compliance with worldwide standards, the ultimate question of its efficacy will be determined by the SAT. ◆