

Notice on the Deduction of Interest Expenses Due to Related Parties in Computing Taxable Income (“The Notice”)

Caishui [2008] 121

The State Administration of Taxation and Ministry of Finance

All provinces, autonomous regions, municipalities directed under the Central Government, finance bureaus of cities under separate state planning, state tax bureaus, local tax bureaus, and the finance bureau of the Xinjiang Production and Construction Corps:

In order to regulate the deduction of interest expenses when computing taxable incomes, and to strengthen the administration of corporate income tax, according to Article 46 of The Law of the People's Republic of China on Corporation Income Tax (hereinafter referred to as the “CIT Law”) and Article 119 of the Rules for The Implementation of the Corporate Income Tax Law of the People's Republic of China (Order of the State Council No. 521, hereinafter referred to as the “Implementation Rules”), the policies for pre-tax deduction of interest expenses for related-party debt investment are given as below:

- 1 In computing the taxable income, an enterprise is allowed to deduct its interest expenses actually paid to its related parties up to the ratio prescribed below and the amount allowed under the CIT Law and the Implementation Rules. The exceeding portion of the interest expenses should not be deducted either in the current year or the following years.

For the actual interest expenses paid by an enterprise to its related parties, the prescribed ratio of its debt investment from related parties to its equity investment (“debt/equity ratio”), apart from those that meet the requirements set in Article 2 of the Notice, should be:¹

- 5:1 for financial institutions
 - 2:1 for other enterprises
- 2 Where an enterprise computes its taxable income, the interest expenses actually paid to its related parties can be deducted if:
 - The enterprise can provide the relevant supporting documents according to the CIT Law, the Implementation Rules, and relevant regulations, and prove that the relevant transactions are conducted at arm's length; or
 - The effective tax rate of the enterprise paying interest expenses to a domestic related party is not higher than that of the domestic related party.

¹ Footnote by the translator: here the meaning of “apart from” is not clear.

- 3 An enterprise engaged in both financial and non-financial businesses should calculate the interest expenses paid to related parties separately. In case it cannot separate the expenses base on a reasonable method, the deductible interest expenses should be calculated based on the debt/equity ratio of the "other enterprises" as set out in Article 1 of the Notice.

- 4 The interest income obtained by an enterprise from related parties that does not meet the regulations should be subject to corporate income tax according the relevant regulations.

September 23, 2008