WANG JING & CO.

Partners: (* Non resident)

J. Wang
X. Y. Chen
S. Z. Zhao
X. M. Shen
G. Y. Jiang
J. Y. Wang
Y. H. Cao
C. Zhong
H. Y. Wang
X. Chen
J. F. Xu
J. Xu
John Wang
Y. Zhao
Z. C. Zou *
L. D. Pan *
H. Yuan *
R. C. Li *
D. H. Song *
F. B. Xu *
S. Z. An *

(A full list of our associates and managers is available on our website.)

Website: www.wjnco.com General Email: info@wjnco.com

Guangzhou office:
11/F., Block D, GT Land Plaza
8 Zhu Jiang West Road
Zhu Jiang New Town
Guangzhou 510623, PRC

Tel: (8620) 8393 0333
3719 0919 (Japanese)
Fax: (8620) 3808 2990

Shanghai office:
Rm. 2807-12, 28/F.
Bank of China Tower
200 Yincheng Road Central
Pudong, Shanghai 200120, PRC

Tel: (8621) 5887 8000
5887 9262 (Japanese)
Fax: (8621) 5882 2460

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New Tax Regulation over Foreign International Transportation Enterprises and its Impact on Maritime Transportation in China

On 30 June 2014, the State Administration of Taxation of China issued a notice for the *Provisional Measures on the Collection of Tax on Non-resident Taxpayers Engaged in International Transportation Business* ("the Provisional Measures"), which came into effect on 1 August 2014. The Provisional Measures aims at the incomes (e.g., charter hire, freight and surcharges, charges for loading and unloading, warehousing costs) received by non-resident enterprises conducting International Transportation Business ("ITB") in China. According to the Provisional Measures, non-resident enterprises are required to declare and pay taxes by themselves or by appointed agents. Besides the self-declaration and payment, tax authority can also designate a tax withholding agent who is legally obliged to withhold part of payment (e.g., charter hire, freight, and other incomes under ITB) to non-resident enterprises. Failure of declaring, withholding, or paying taxes can result in compulsory payment of tax due, fines, and penalties.

In pre-2014 era, although legally speaking, non-resident enterprises should declare and pay tax for the income received from ITB, such legal requirements were not strictly enforced by tax authority. There was no specific regulation guiding or demanding foreign companies to declare or pay tax. The major mechanism for collecting taxes on ITB was tax collection at source through withholding agents. In the *Circular of the State Administration of Taxation on Issues concerning the Calculation and Collection of Enterprise Income Tax on Watercraft and Aviation Transportation Incomes of Non-resident Enterprises* (Guo Shui Han [2008] No.952), the tax authority prescribed a unanimous withholding rate of 4.25%, comprising Business Tax (3%), and Enterprise Income Tax ("EIT," 1.25%), applicable to all revenue received from ITB, and required withholding agents, most of the times, Chinese charterers, to withhold 4.25% of the amounts (e.g., charter hire) that they were going to pay to foreign Owners. In fact, some withholding agents applied a higher withholding rate because they misunderstood, and thought of time charter hire as income arisen from property leasing or royalties, instead of transportation services. In contrast, for those ITB with no Chinese charterers involved, neither business tax nor ITB is actually levied.

Now the newly adopted Provisional Measures define ITB as transportation into or from Chinese ports, and provide that all ITB will be subject to EIT. It seems that even a shipment without a Chinese charterer involved could be considered as ITB, and therefore taxable in accordance with the Provisional Measures. Such distinct perspective gives rise to two uncertainties. Firstly will the tax attach if a foreign Owner charters a vessel to a Chinese charterer, but the transportation is among foreign ports? Previously such income is subject to business tax, but not EIT. Another is that whether the tax will apply if a foreign Owner charters a vessel to a foreign Charterer, and no Chinese Charterer involved, but the vessel calls at Chinese ports. So far, the State Administration of Taxation gives no clarification in this regard.

The Provisional Measures defines Total Income under ITB and provides that actual, reasonable, and relevant expenses are deductible. In Article 7, the Provisional Measures explain that a Taxable Income is the balance of Total Income minor Deductible Expenses. The applicable tax rates (e.g., 10%, 20%, and 25%) are provided by the Law of the Enterprise Income Tax, and other related regulations. The tax to be paid is the result of multiplying Taxable Income with applicable tax rate. As a supplementary method to the above standard calculation, the Provisional Measures refer to the *Circular of the State Administration of taxation on Issuing the Administrative Measures for the Assessment and Collection of Income Tax against Non-resident Enterprises* (Guo Shui Fa [2010] No.19), which empowers tax authority to assess profit rates for tax payers and apply the profit rates to calculate Taxable Income. The Provisional Measures also provide detailed procedures for tax withholding, registration and declaration, account book setting, and tax treaty benefit application. Below is a brief review of the several salient points in the Provisional Measures.

1. What is International Transportation Business ("ITB")?

According to the Provisional Measures, ITB refer to transportation services of passengers, cargoes, mails, or others into or out of China via self-owned or leased ships, airplanes and shipment slots, and the relevant subsidiary business such as loading, unloading, and warehousing.

The Provisional Measures explicitly provide that voyage charter and time charter are ITB and therefore are subject to the applicable tax rate for transportation services under the Provisional Measures. This clarification ends the long debate of whether charter hire under time charter shall be deemed as income from transportation services, or property leasing. Incomes from property leasing are subject to different tax rates, and sometimes are not included into tax treaties for tax exemption.

2. Who should pay taxes?

A Non-Resident Taxpayer ("NRT") refers to a company incorporated outside China in accordance with foreign laws, and whose actual administrative institution is outside China, and who may or may not have institutions or establishments in China. NRTs engaging in ITB in China should pay taxes in accordance with the Provisional Measures.

3. What are Total Incomes, Deductible Expenses, and Taxable Income?

Total Incomes include, among others, all freight and surcharges, charter hire, passenger ticket revenue, service charges, and any other amount received from the provision of ITB. The Deductable Expenses refer to the actual, reasonable, and related expenses for ITB (e.g., running costs, crew salary, fixed asset depreciation, ports costs, and bunkers). In practice, the tax authority usually adopts a very strict review to the Deductible Expenses, and requires all these expenses should be well supported by written evidence, and sometimes sets upper limit to certain expenses. After fixing Total Income and Deductible Expenses, the tax authority can compute the Taxable Income, the difference of the above two.

4. How the tax is calculated?

The basic rule is to multiply the Taxable Income by an applicable tax rate. Depending on the actual circumstances, the applicable tax rate could be 10%, 20%, or 25%. If a NRT cannot accurately compute or truthfully declare its Taxable Income, the tax authority can adopt an Assessment Collection, by which the tax authority will prescribe a deemed profit rate, usually not less than 15%, to the NRT, and calculate an Ascertained Taxable Income by multiplying the Total Income by the assessed profit rate. The tax will be the result of multiplying Ascertained Taxable Income with applicable tax rate.

5. How the tax is collected?

Self tax registration, declaration, and payment

Within 30 days upon obtaining the business qualifications from relevant authorities or conclusion of transportation contracts/agreements, the NRT shall by itself or by proxy go through the registration formalities at a competent tax authority in places (e.g., a Chinese port) where it conducts ITB. Necessary items for registration include business certificate, relevant business contracts, voyage details, contact points in China, and other documents or information required by the tax authority. After successful registration, the NRT shall set up account books, keep account voucher, carry accounting in accordance with applicable accounting rules to compute income and expenses accurately. Tax shall be declared, and paid monthly or quarterly.

Collection at source through a withholding agent

Besides the above self-declaration method, the Provisional Measures also prescribes tax withholding via agents. Withholding agents are parties making payment to NRTs, their subsidiaries, branches or agencies or foreign agents, or parties effecting payment through its associated foreign parties or interested third party. They are obliged to withhold part of their payments to NRTs, and pay the same to tax authority. Because withholding agents usually do not have information or documents necessary for computing incomes and expenses accurately, they will apply the above Assessment Collection mechanism, and use a profit rate not less than 15% to calculate Taxable Income. Assuming the withholding agent is a Chinese charterer and an applicable tax rate of 10%, the tax will be no less than 1.5% (i.e., profit rate 15% × tax rate 10%) of the charter hire. Furthermore, the withholding agent is obliged to withhold not only EIT under the Provisional Measures, but also other taxes (e.g., Value Added Tax).

6. Tax treaties on avoidance of double taxation or on maritime transportation

For the NRT residing in countries (e.g., Cyprus, and Greece) concluding tax treaties with China, the NRT can apply a tax exemption in accordance with such tax treaties. The NRT should file such application with supporting documents, including Enterprise Registration Certificates, Certificate of Legal Person, contracts or Charter Party, voyage description, and other documents requested by tax authority.

In addition, on a larger scale beyond the framework of the Provisional Measures dealing with the EIT, other taxes (e.g., Value Added Tax, imposed as a replacement to the Business Tax in accordance with the on-going tax reform in China) may also apply when foreign Owners are engaging in ITB within China. In overall, China has tightened up the tax regulation for ITB, and Owners should be vigilant, and always take various taxes into consideration before concluding Charter Party with Charterers.

Yours faithfully,

Wang Jing & Co.