# The Guarantee of Company Financing Neutrality in Chinese Tax System: an Analysis Based on the Regime Package, Involving Thin Capitalization Rules and Other Relative Rules, Following the 2007 Reform of New Enterprise Income Tax Law

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## 1. Introduction

### 1.1. Tax factors affecting the decision-making of financing methods and tax neutrality: different tax treatment on financing costs between debt financing and equity financing

Speaking of capital source, there is no doubt that besides the internal financing, the external financing is the other indispensable and crucial approach to which the enterprises can resort. In the case of external financing, the debt financing and the equity financing constitute two methods between which the enterprises seeking financing should make a choice. Actually the financing preference of company, the term used frequently in the study of company capital structure, is exactly the result assessed in the process of choice-making, conducted by company, with respect to financing methods aforementioned. Herein, we follow closely an issue of the factors that affect the enterprise's decision-making with respect to financing methods and then determine the financing preference of a company, consisting of both tax factors and non-tax ones from the viewpoint of tax as a dividing line. And we have to admit that the tax factors are really the considerably impactive ones in the business operations for the companies, not only in the decision as to how

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to choose the financing methods, and we can find out that in general the tax system provides a preference for debt, given that on one hand, interest on debt is deductible from the tax base and on the contrary dividends on equity are not, and on the other hand, the rate of withholding income tax applied to the interests obtained by the non-resident taxpayer is usually lower than that applied to the dividends, these two aspects combining to reach the outcome of reducing the tax burden borne by enterprises, and accordingly, the enterprises are usually more indicative of debt financing preference, being supported under the pecking-order theory by Myers and Majluf (1984) which predicts that firms will use internal financing sources first and revert to external debt and, even more reluctantly, to new equity only after internal sources of finance have been exhausted[2]. But what is worth mentioning is that the financing preference shown by Chinese companies is different from that shown by companies of western countries, in the other words, currently the Chinese companies are more of equity financing preference because of the lax restriction on capital cost of companies, the investors' lack of investment consciousness and the lack of withdrawing mechanism from capital market[3]. And yet, does this also mean that the tax factors that undermine the tax neutrality have only a slight impact with the result that non-tax factors prevail over tax factors, for the enterprises to make a decision of whether to resort to debt financing or equity financing, in China? I will try to answer this question in the last but one section of this present article after exploring the Chinese regime package with respect to deduction of financing costs.

It should be noted that whatever the financing preference shown by Chinese companies or by companies of western countries may be, from the tax factors perspective only, to some extent, these existing factors affecting the

[2] Alfons J. Weichenrieder - Tina Klautke, *Taxes and the Efficiency Costs of Capital Distortions*, CESifo Working Paper Series No. 2431.

[3] 宋琳：资本成本与融资成本的辨析及对我国公司融资偏好的影响 ——兼与黄少安教授商榷，工作论文. (Song lin, *the analysis of capital cost, financing cost and their impact on the financing preference of Chinese company*, work article)(2008-05-03).

decision-making of financing methods both in China and in western countries violate the principle of tax neutrality requiring that tax not cause individuals or firms to shift their economic choices. As pointed out above, the tax factors in question mainly refer to the disparate treatment of interest payments and dividends under the typical enterprise income tax. Regarding the case of China, under Art.8 of the Enterprise Income Tax Law (hereinafter: EITL) after the 2007 reform of Chinese enterprise income tax[4], reasonable expenses that are relevant to the income actually incurred and obtained by enterprises, including costs, fees, tax payments, losses and other fees, are allowed to be deducted from the taxable income. And the interest expense incurred by enterprise in the production and business operation activities falls within the scope of reasonable expenses. On the contrary, Art. 10(1) of EITL provides that income from equity investment paid to investors such as dividend and bonus is not allowed to be deducted from the taxable income. Considering that this legislation dedicated to disparate treatment of interest payments and dividends is ineradicable, especially in China, it is nearly impossible to adopt the integration schemes that permit a corporation to deduct dividends paid or, somewhat equivalently, allow its shareholders to claim a credit for some or all of the income taxes paid by the corporation[5], for the purpose of dealing with the tax-induced distortion caused by the violation of tax neutrality under this legislation, what we can do is just to relieve as much as possible this kind of distortion by way of the reduction of corporate tax rate, the restriction on deduction of interest expense or other manners.

[4] This EITL is adopted at the 5th Session of the 10th National People's Congress on 16 March 2007, promulgated by Order No. 63 of the President of the People's Republic of China and effective as of 1 January 2008. It should be stressed that this remarkable new Chinese EITL has ended the double-track system meaning that the applied provisions with respect to enterprise income tax differed according to enterprise identity, namely domestic-funded enterprise or foreign-funded enterprise, along with the considerable differences in respect of tax treatments between these two kinds of enterprises.

[5] Regarding the integration schemes, *See* Michael J. McIntyre, *The Deduction of Interest Payments in an Ideal Tax on Rea*lized Business Profits, Wayne State University Law School Research Paper No. 08-21.

### 1.2. Measures to guarantee company financing neutrality from the international practice perspective and the choice of China

As explored above, some solutions should be offered to the problem of tax neutrality in respect of company financing under the Chinese current tax regimes, aiming at guaranteeing company financing neutrality. From the global point, it's no exaggeration to say that tax neutrality with respect to the debt-equity choice is one of the most frequent demands in discussions about corporate tax reforms. Accordingly, many various measures to guarantee company financing neutrality have emerged from the tax reforms that some certain countries underwent, for instance, the interest barrier introduced by 2008 German business tax reform[6] and followed by 2008 wide reform of the Italian tax system a few months later[7], a dual income tax and the thin capitalization rules fixed in Italian previous regimes, etc. As to China, the measures in discussion are included in regime package following the 2007 reform of enterprise income tax and this regime package constitutes the big picture regarding restrictions on interest expenses, in order to avoid excessive indebtedness of enterprises. This regime package includes the general limitation rule, the thin capitalization rules which are relatively traditional compared to the regime of interest barrier, and other rules as represented by the circular[8] of Guo Shui Han 2009 n. 312 issued by State Taxation Administration providing that the interest expenses incurred in case of investment not completely in place carried out by investors are not allowed to be deducted from the taxable income in proportion to non paid-in capital in capital to be paid. This set of rules is the subject matter of the present article,

[6] Tino Müller-Dutiné - Marc P. Scheunemann, *New German Tax Rules on Financing Expenses*, Intertax, 35/2007, p. 518–525

[7] Giuseppe A. Galeano - Alan M. Rhode, *Italy Sets the Barrier to Deduction of Financing Costs at 30 Per Cent of EBITDA*, Intertax, 36/2008, p. 292–301

[8] It's entitled "Reply of the State Administration of Taxation on the Issue of Deduction of Interest Expenses Incurred in the Case of Investor's Investment not in Place for the Enterprise Income Tax Purpose".

but with more attentions focused on the first two rules and their relevant tax regimes.

## 2. Exploration of the regime package with respect to deduction of financing costs

### 2.1. Definition of dividend and interest according to EITL of China

**Before exploring the set of rules regarding the restrictions on deduction of financing costs, it's necessary to start with the overview of rules directed towards the definition of dividend, interest and other relevant concepts in accordance with the EITL of China and its implementation regulation[9]**

Under Art. 17 of the Implementation Regulation of EITL (hereinafter: Implementation Regulation), the dividend and profit distribution, etc.. from equity investment as stated in Art. 6(4) of EITL shall refer to the income derived by an enterprise from its investee as a result of the equity investment made therein. And under Art. 18 of the Implementation Regulation, interest income as stated in Art. 6(5) of EITL shall refer to income derived by an enterprise from the provision of funds for other parties to use but not constituting equity investment, or from the possession of its funds by other parties, including deposit interest, loan interest, bond interest, arrear interest, etc.. Despite the fact that these two aforesaid articles define the concepts of dividend and interest from the viewpoint of income, not as the payments, the basic characteristics that qualify the dividend and interest can be extracted clearly from these two articles. First, the term of equity investment is crucial for the definition of dividend and also for the interest in light of its definition

[9] The Implementation Regulation of EITL of China is adopted on 6 December 2007 and promulgated by Order N. 512 of State Council (China).

with negative terms and to some extent how to define the equity investment from which the dividend originates determines the definition of dividend. Under Art. 119 of the Implementation Regulation, equity investment refers to investment obtained by an enterprise without the need of the repayment of principal or interest, and the investor having the entitlement to the net assets of the enterprise. It is clear that its monetary value amounts to the balance of enterprise assets minus enterprise liabilities and currently its existing forms in China include ordinary stock, privileged stock, stock right and share warrant etc. But it should be noted that although the article defining the interest does not make reference to the debt investment, it does not spell irrelevant for debt investment in the definition of interest. Considering that the debt investment will be illustrated detailedly hereinbelow, namely in the subsection concerning thin capitalization rules, herein only the basic definition is pointed out for the purpose of offering a simple comparison with the definition of equity investment. Under the same Art. 119 of Implementation Regulation, debt investment refers to investment obtained by an enterprise requiring repayment of principal and interest, or other forms of compensation with an interest element. As a matter of fact, besides recovering the principal and interest on schedule, in general the Chinese companies carrying out the debt investment are also in pursuit of the interest at rate above the bank deposit rate. Secondly, from the definition article regarding the interest, the essential point we can draw is that the interest concerned is incurred in the only case of grant of funds and this approach corresponds to the general definition with respect to interest, saying that interest is the consideration in return for the temporary grant of cash. Therefore, some payments in consideration for lending assets, such as rental, are distinguished from the interest.

## 2.2. Deduction of interest expenses on different types of loans or debts

Regarding the tax regimes with respect to deduction of interest expenses, being the subject matter of the present article, first of all it needs to be made clear that by making a general survey, these regimes differ according to whether or not the subjects that grant or guarantee loans or debts to which the interest expenses incur are related to the takers of loans or debts. In other words, the Chinese tax regimes with respect to the limitations to the deduction of interests pay close attention to the independence or dependence of debt financing relationship. Therefore, this part is divided into two main subsections: that concerning the unrelated party and that concerning the related party.

### 2.2.1. Loan or debt granted by unrelated party

In the case of loan or debt granted by unrelated party, the definition of related party being illustrated detailedly hereinbelow, the fundamental provision in relation to the deduction of interest expenses on loan or debt granted by non natural person is the Art. 38 of the Implementation Regulation. In accordance with the item (1) of Art. 38, interest expense on borrowing from financial enterprises by a non-financial enterprise, interest expense paid on various saving deposits and inter-bank borrowings as incurred by financial enterprises and interest expense incurred by an enterprise on bonds approved for issuance, are entitled to be deductible. In accordance with the item (2) of Art. 38, for interest expenses on borrowings from non-financial enterprises by a non-financial enterprise, the portion that does not exceed the amount

calculated by reference to the interest rate of similar loan with the same term as provided by financial enterprises are entitled to be deductible. It should be noted that the interest expenses as stated both in item (1) and in item (2) must be incurred in the production and business operation activities. Regarding the Art.38, the two following aspects should be specified:

1) Full deductibility. In reality, the item (1) of Art. 38 of the Implementation Regulation provides four cases in each of which the interest expenses incurred are fully deductible, including loans granted by financial enterprises to a non-financial enterprise, various saving deposits, inter-bank borrowings and bonds issued by enterprises with approval. The reason why it's provided for the interest expenses incurred in these cases with full deductibility is, to some extent, the extremely high-leveraged activity which the financial enterprises carry out. It needs to be added that according to the Art. 2 of Chinese Financial Enterprise Accounting System[10], in China the financial enterprises refer to bank including credit association, insurance company, securities company, trust and investment company, futures company, fund management company, leasing company and finance company, etc..

2) Application of general limitation. Notably, the item (2) of Art.38 of the Implementation Regulation involves a general limitation to the deduction of interest expenses applied to the case outside the cases as stated in the item (2), namely the case of borrowings from non-financial enterprises by a non-financial enterprise, providing that the maximum amount of deductible interest expenses incurred in the case concerned is that calculated at interest rate of similar loan with the same term as granted by financial enterprises. It should be noted that this general limitation is set for each loan or debt and can be called the "per-loan" check. This provision aims at preventing enterprises form reducing the tax base through the deduction of huge and unreasonable interest expenses. However, it should be indicated that this provision is

[10] It is promulgated by Ministry of Finance (China) on 27 November 2001.

somewhat ambiguous, meaning that the lawmakers do not clarify what the interest rate of similar loan with the same term refers to and how to determine the loan as granted by financial enterprises , with the same term, that can be qualified as similar to the loan in case. For the first question, it's argued that the interest rate in question should refer to the benchmark interest rate plus floating interest rate, given that the interest rate of loan as granted by financial enterprises consists of benchmark interest rate and floating interest rate according to the provisions of People's Bank of China. It is worth mentioning that compared to the former regimes, the Art. 38 of the Implementation Regulation employs the concept of "financial enterprises" instead of "financial institutions", and as a result, it can be held that the benchmark interest rate and floating interest rate fixed by People's Bank of China are excluded, given that People's Bank of China belongs to the non-profit and administrative financial institution and falls outside the scope of financial enterprises which engage in business operations for the purpose of profit. For the second question, in practice it is determined on the basis of the use of the loan by differentiating various loan categories, such as investment loan, consumption loan, housing loan, educational aid loan, pledge loan and so on.

What is mentioned above involves exclusively the legislation on the deduction of interest expenses on loan or debt granted by non natural person in the unrelated party matter, and now we examine the relevant legislation in respect of natural person not constituting the related party. In this respect, it was of ambiguity and dispute before promulgating the circular[11] of 2009 Guo Shui Han n. 777 of the State Taxation Administration which has opened the door of hope for enterprises to deduct the interest expenses on borrowings provided by natural person and meanwhile has brought in the beacon of hope

[11] It's entitled "Notice of the State Administration of Taxation on the Issue of Deduction of Interest Expenses on Borrowing Provided by Natural Person for the Enterprise Income Tax Purpose".

to alleviate the financing problems for the small and medium-sized enterprises. This circular provides that the enterprises are entitled to deduct the interest expenses on borrowings provided by independent natural person, on condition that both of the two following requirements are met: (1) the debtor-creditor relationship between enterprise and individual is authentic, legitimate and valid, without illegal fund-raising purposes and other behaviors that violate the laws and regulations; (2) the two parties have signed the loan contract. It should be pointed out that the general limitation, namely only the portion that does not exceed the amount calculated by reference to the interest rate of similar loan with the same term as provided by financial enterprises are entitled to be deductible as explained above, also applies to the case in discussion.

### 2.2.2. Loan or debt granted by related party

#### 2.2.2.1. Definition of related relationship and categories of related party

After having explored the regimes regarding the deduction of interest expenses on the loan or debt granted by unrelated party, now we enter into the exploration of the deduction of interest expenses in the related party matter. It is no doubt that what the definition of related party is, or how to judge a subject as a related party, is crucial for the application of the rules with respect to deduction of interest expenses under exam, namely for the application of thin capitalization rules that should be taken seriously, albeit the Chinese provisions defining the related relationship serve not only for the thin capitalization rules, but also for some other rules regarding special tax adjustment, for example, the transfer pricing rules.

Under Art. 109 of the Implementation Regulation, a related party refers to an

enterprise, an organization or an individual that has one of the following related relationships with the debtor enterprise: (1) direct or indirect control in respect of capital, business operations, purchases and sales, etc..; (2) direct or indirect common control by a third party; (3) any other relationships arising from mutual interest. It is clear that this provision is a principle norm and lacks the operability for the qualification of related party, meaning that it is still difficult to judge whether a subject can be considered as a related party according to this provision without the concrete criteria. Therefore, in the circular[12] of 2009 Guo Shui Fa n. 2 of the State Taxation Administration (hereinafter: circular No. 2/2009), the concept of related relationship is defined in detail for the purpose of applying Art. 109. Under Art. 9 of this circular, the related relationship refers to one of the following relationships the other enterprise, organization or individual has with the debtor enterprise: (1) one party directly or indirectly holds at least 25 per cent stake in the capital of the other party, or the same third party directly or indirectly holds at least 25 per cent stake in the each capital of the two parties. When a party indirectly holds the stake in the capital of the other party through an intermediate party, only if the stake the one party holds in the capital of the intermediate party reaches or exceeds 25 per cent, the shareholding ratio of one party in confront with the other party amounts to the shareholding ratio of the intermediate party in confront with the other party[13]; (2) the loan funds existing between one party and the other party, with the exception of independent financial institution, account for more than 50 per cent of the paid-in capital of one party, or more than 10 per cent of the total amount of one party's loan funds is guaranteed by the other party, with the exception of independent financial institution; (3) more than one half of one party's senior management

[12] It's entitled "Notice of the State Administration of Taxation on Issuing the Measures for the Implementation of Special Tax Adjustments (for Trial Implementation)".
[13] In effect, taking the case of indirect holding into account helps to avert leaving door for abuse.

personnel including board members and managers, or at least one senior member of the directorate of this party who can control the directorate, is appointed by the other party, or more than one half of each party's senior management personnel including board members and managers, or at least one senior member of each party of the directorate who can control the directorate, is appointed by the same third party; (4) more than one half of one party's senior management personnel including board members and managers simultaneously holds the position of the other party's senior management personnel including board members and managers, or at least one senior member of one party of the directorate who can control the directorate simultaneously holds the position of the other party's senior member of the directorate; (5) only if with the concessions, such as industrial property rights, proprietary technology, provided by the other party, one party's activities of production and business can work correctly; (6) one party's activities of purchase and sale are controlled by the other party; (7) the services' acceptance and supply of one party are controlled by the other party; (8) one party's production, operation and transaction are under the substantial control of the other party, or there exist other related relationships between two parties, including the situation as stated in paragraph (1) where the shareholding ratio is not up to 25 per cent, but one party enjoys the same economic interests as the other party's major shareholder does, and kinship or relatives relationship and so on.

Based on foregoing, we deem that when the debt enterprise falls into one of the relationships, as revealed above, with any subject such as other enterprise, organization or individual, the debt enterprise and this subject being as a respective party of the relationship without differences as to whether the debt enterprise plays the role as the "one party" or "the other party", this subject shall be considered as the related party of the debt enterprise with a consequence of falling within the scope of thin capitalization

rules. Apart from this, in my view, the methods that should be taken into account in the course of judging whether or not a subject falls into the related relationship with the debt enterprise are highly multiple and complicated, involving the employment not only of capital the choice of which is relatively universal, but also of other relationships with dominant influence, including the composition of senior management personnel, the control of activities of production and business through peculiar contract, and kinship or relatives relationship, provided that the subjects concerned are individuals, namely when as an individual, the debt enterprise's major shareholder has kinship or relatives relationship with other individual as the creditor. As a result, we have to acknowledge that the enterprises operating in China should take their business operations carefully just as much as one skates over the ice, otherwise it would be easily trapped into the situation of related party with the result that they would be subject to the disadvantageous tax regimes concerning the related party, like the thin capitalization rules.

Thus we can infer from the above exploration that on one hand, either enterprise shareholder or subject other than an enterprise shareholder, and on the other hand, either legal person or non legal-person organization including natural person, can constitute the related party.

#### 2.2.2.2. Application of thin capitalization rules besides general limitation

Now, let's look at the thin capitalization rules in more detail that apply to the case of deduction of interest expenses on loan or debt granted by related party. Under Art. 46 of EITL, in case the ratio of comparing debt investment accepted by enterprise from its related parties to equity investment exceeds the prescribed ratio, the excessive interest expenses incurred to the portion of

debt investment out of the prescribed ratio are not deductible from the taxable income. Apart from this provision, the circular[14] of Cai Shui No.121/2008 of the Ministry of Finance (hereinafter: circular No. 121/2008) provides further that for the interests paid by enterprise to the related parties, only the portion not exceeding either of the amounts calculated on the basis of the prescribed ratio and under the EITL and its Implementation Regulation is entitled to be deducted, and the portion in excess of either of the aforesaid amounts shall not be deducted from the current period of occurrence or future fiscal years. It should be noted that Art. 46 of EITL, for the first time, has expressly introduced the thin capitalization rules into the Chinese tax system, and besides thin capitalization rules, also the rule regarding general limitation[15] referable to the amount calculated under the EITL and its Implementation Regulation applies to the deduction of interest expenses on loan or debt granted by related party. Apart from this, it needs to be stressed that to really achieve the legislative goal of thin capitalization rules, what we should bear in mind is that the non-deductible portion of interest cannot be carried forward to future fiscal years, just as the circular No. 121/2008 emphasizes.

In effect, the thin capitalization rules are seldom straightforward and the Chinese one is no exception. In practice, a detailed analysis of the rules requires going through the following explorations, each of which will be the subject matter of one of the subsequent paragraphs:

A. Scope of subjects for the purposes of application of the thin capitalization rules. In this connection, it should be said that in China all enterprise income tax subjects including non-resident enterprises are within the scope of thin capitalization rules and no exception as provided for by, for instance, Italian former thin capitalization rules to small sized enterprise and financial

[14] It's entitled "Notice of the Ministry of Finance and State Administration of Taxation on Issues Relevant to the Tax Policies Regarding the Criteria for Enterprises' Pre-tax Deduction of Interest Disbursements to Affiliated Parties".

[15] It refers to the item (2) of Art.38 of EITLas already examined in the part of "Loan or debt granted by unrelated party".

enterprises[16], is currently provided by relevant Chinese rules, at least from the viewpoint of literal reading. Accordingly, the Chinese thin capitalization rules also apply to the financial enterprises that generate the interest expenses incurred to the debt investment by the related party, albeit with some different specification, as well as the small sized enterprises.

B. Scope of objects: interest expenses and other similar expenses. Under Art. 87 of the circular No. 2/2009, the interest expenses as stated in Art. 46 of EITL include interest, guarantee fee, mortgage fee and other fees in the nature of interest that are incurred to direct or indirect debt investment and are actually paid by the enterprise.[17] From this provision, we can infer that the term of interest expense not only includes the consideration calculated as interest, but also some other given considerations, e.g. guarantee fees, mortgage fees and other fees in the nature of interest. Compared to the circular[18] of Guo Shui Fa No. 84/2000 of the State Taxation Administration by which the interest expenses are defined exclusively as interest fees that are related to the borrowed funds, Art. 87 has extended the scope of interest expenses to be adjusted, corresponding to the extension of scope of related debt investment into which the indirect debt investment falls, illustrated hereinbelow.

C. Twofold debt-equity ratio. Under the circular No. 121/2008, the debt-equity ratio for the purpose of application of thin capitalization rules refers to that of 5 to 1 and that of 2 to 1, respectively for the financial enterprise and for the other enterprises. This is the Chinese system of twofold debt-equity ratio: on one hand, being different from some other country where the financial enterprises are exempted from the application of thin capitalization rules, China has applied the thin capitalization rules also to the financial enterprises

[16] Michele Gusmeroli - Massimiliano Russo, *Italian Thin Capitalization Rules, Tax Treaties and EC Law: Much Ado About Something*, 32/2004, Intertax, p. 493–519.

[17] The interest that is actually paid refers to that which is recorded as cost or fee according to the accrual basis principle.

[18] It is entitled "Notice of the State Administration of Taxation on issuing the Method of Pre-tax Deduction for the Enterprise Income Tax Purpose".

but setting the high debt-equity ratio of 5 to 1, meaning that the Chinese financial enterprises are not subject to rigid thin capitalization rules in light of the fact that the lower the debt-equity ratio is, the more rigid the thin capitalization rules are. Accordingly, on the other hand, the appropriate debt-equity ratio of 2 to 1 is set for the non-financial enterprises in consideration of the equilibration between the requirement of restraining the deduction of unreasonable interest expenses and the requirement of avoiding some side effects brought out by rigid thin capitalization rules, such as the confinement produced to the flow of international capital. It should be indicated that as stressed by the circular of No. 121/2008, where an enterprise engages simultaneously in financial business and non-financial business, the interests actually paid to the related parties shall be calculated separately, namely shall be divided into respectively the part for the financial business purpose and the other part for the non-financial business purpose, based on reasonable methods, and where the interests are not separately calculated based on reasonable methods, the calculation of deductible interest expenses shall be performed uniformly according to the debt-equity ratio for non-financial enterprises.

It is certain that to grasp as precisely as possible the debt-equity ratio, more details should be given. Regarding these details, we analyze here below the following aspects:

a) Debt investment qualified for the purpose of thin capitalization rules. Undoubtedly, grasping precisely the connotation of debt investment and equity investment is the precondition on which the correct application of debt-equity ratio depends. Here we supplement some more concrete provisions with respect to debt investment that follow the basic provisions defining the debt investment. As already introduced above, debt investment refers to investment, directly or indirectly, obtained by an enterprise, from its related parties, requiring repayment of principal and interest, or other forms of

compensation in the nature of interest for the purpose of thin capitalization rules, and the Art. 119 of Implementation Regulation provides further that the debt investment indirectly obtained by an enterprise from related parties include the following three cases: (1) debt investment granted by a related party through an unrelated third party; (2) debt investment granted by an unrelated party that is guaranteed and pledged with joint liability by the related party; (3) any other debt investment indirectly made by the related party with the substance of debt. Based on this provision, we can clearly hold that not only the direct debt financing from the related party falls within the scope of debt investment for the thin capitalization rules purpose, but also the indirect debt financing from the related party does, the latter including the forms such as the back-to-back loan, namely the case where, for example, first the related party deposits the money in a bank, next this bank grants a loan to the enterprise, and secured loan by related party disguising the loan between related parties as an independent third-party loan. It is clear that this helps to prevent the taxpayers from abusing rules in this respect[19].

b) "Overall" check. It should be stressed that the debt-equity ratio that determines the threshold is the result of comparing the volume of debt investment accepted by enterprise from all its related parties to the volume of all the equity investment of this enterprise according to Art.85 of the circular No. 2/2009. In other words, interest expenses on loans or debts granted by related parties are not deductible, to the extent such loans or debts exceed five times in financial enterprise matter, or two times in non-financial enterprise matter, the equity of the debt enterprise. This is the so-called

[19] And yet, it should be indicated that the Chinese current rules in terms of related debt investment are just general rules, meaning that they do not provide specific and different policies to different forms of loan. For example, neither short-term loan nor back-to-back loan is provided with specific treatments as provided by some foreign thin capitalization rule according to which for the certain short-term loan, it is excluded from the debt capitals for the purpose of calculation of debt-equity ratio when the interests on it are not paid, and for the back-to-back loan, the interests on it can not be deducted absolutely, along with its exclusion from the total amount of capital. In fact, we argue that these specific treatments should be introduced by the future amendment of Chinese thin capitalization rules.

"overall" check applied in Chinese thin capitalization rules to the extent only related parties' debt is compared to all shareholders' equity.

c) Computational formula of debt-equity ratio. According to Art. 86 of the circular No. 2/2009, this computation formula is as follow:

debt-equity ratio = sum of the monthly average related debt investments over fiscal year / sum of the monthly average equity investments over fiscal year there among:

sum of the monthly average related debt investments = (related debt investments' book balance of beginning of month + book balance of end of month)/2;

sum of the monthly average equity investments = (equity investments' book balance of beginning of month + book balance of end of month)/2.

From the formula, we can infer that regarding timing issues, namely the acknowledging time of loan capital, the Chinese thin capitalization rules have adopted the averaging method based on the monthly average loan balance under one whole fiscal year.

D. Tax treatments of non-deductible interest expenses. As already indicated above, as a rule, the non-deductible portion of interest expenses under the Chinese thin capitalization rules cannot be carried forward to future fiscal years, and it needs to be here added that what the further tax treatments in relation to the non-deductible portion of interest expenses are provided for by the Chinese thin capitalization rules. In this respect, Art. 88 of the circular No. 2/2009 is the provision concerned according to which the non-deductible interest expenses should be distributed between all the related parties concerned and the portion among them attributable to one related party corresponds to the proportion of the interests actually paid to this related party in the total interests to be paid to all the related parties. Moreover, under Art. 88, the portion of non-deductible interests that is distributed to the domestic related party whose actual tax burden is heavier than that of the

debtor enterprise is entitled to be deducted and the portion that is actually paid, directly or indirectly, to the related party abroad shall be treated as distributed dividends and shall be taxed for the purpose of tax supplement at rate of difference between the rate applied to taxation of dividends and the rate applied to taxation of interests, and in case the income taxes that are already withheld exceed the income taxes calculated according to dividends, the excess portion is not refunded[20]. Regarding this provision, there are two following aspects to be, respectively, stressed and explained:

a) Regrant of deductibility. In light of the fact that the non-deductible portion of interest expenses for the purpose of thin capitalization rules should be further distributed between all the related parties based on certain proportion, as a consequence, the tax treatments on these non-deductible interests differ according to whether the related party that obtains the corresponding interest income is the domestic related party or related party abroad. In the case of the former, for the debtor enterprise the deductibility is regranted to the portion, that originally should not be deducted, that is distributed to the domestic related party, on condition that this domestic related party's tax burden is heavier than that of the debtor enterprise. In reality, here the tax regime regarding regrant of deductibility ranges from the escape clause illustrated hereinbelow.

b) Re-characterization of the interest as a dividend. In this connection, the last paragraph of Art. 11, both in the OECD Model Tax Convention and UN Model Tax Convention, provides that "Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been

[20] It should be indicated that Art.88 does not provide an explicit tax treatment to the situation where the portion of non-deductible interests that is distributed to the domestic related party whose actual tax burden is not heavier than that of the debtor enterprise. In this connection, we argue that also this portion, like the portion that is distributed to the related party abroad, should be treated as dividends.

agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention". In reality, also in the tax conventions concluded by the Chinese government and foreign governments, the aforesaid provision is generally included[21]. According to this provision, we deem that having regard to the interests, the part that can enjoy the preferential treatment under the tax convention is only that which is in line with the principle of independent transaction and the part that is not cannot enjoy the preferential treatment under the interest clause in the tax convention, along with the result that this part is not treated as interest. Accordingly, as an extremely important consequence of thin capitalization rules, Art. 88 of the circular No. 2/2009 has re-characterized the interests, deriving from the non-deductible interest expenses and being distributed to the related party abroad on a pro rate basis, as dividends[22] and further provides that the withholding income tax would be levied on these dividends at difference rate, for example, at rate of 3%, provided that the withholding income tax is levied, on one hand, on the interests at the preferential rate of 7% and, on other hand, on the dividends at rate of 10%, according to the tax conventions. In the other way round, the excess taxes are not entitled to be refunded, provided that the withholding income tax is levied on the interests at rate of 10% and on the dividends at rate of 7%[23].

[21] Regarding this, for example, *see* Art.11of Agreement between the Government of the People's Republic of China and the Government of the Republic of Italy for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income.

[22] Being different from the former Italian thin capitalization rules according to which re-characterization of interest as a dividend only applies to loans granted by a related party and when a guarantee is being provided, no constructive dividend will arise, the Chinese thin capitalization rules do not exclude the indirect debt investments-among them, debt investment granted by an unrelated party that is guaranteed and pledged with joint liability by the related party-from the application of the rule regarding re-characterization of interest as a dividend.

[23] It should be pointed out that in the situation of qualifying excess interest expenses as dividends, the issue of economic double taxation arises.

E. Escape clause. In the last place, we need to explore the escape clause for the application of thin capitalization rules. Under the circular of No. 121/2008, where the enterprise is able to provide relevant information, according to EITL and its Implementation Regulation, to prove that relevant activities of transaction are in accordance with the principle of independent transaction, or where the tax burden borne by this enterprise is lighter than that borne by the domestic related party, the interest expenses actually paid to the domestic related party are entitled to be deducted from the taxable income. Regarding this escape clause, we deem that the Chinese thin capitalization rules have provided two situations to which the rules do not apply and where all the interest expenses concerned are deductible: one is that the enterprise provides the proof that the relevant transaction between itself and its related party is performed under the principle of independent transaction, and the other is that the tax burden of the enterprise is lighter than that of the domestic related party. And yet, the wording of this escape clause is somewhat puzzling: on one hand, there is no doubt that for the latter situation, the escape clause applies only when the domestic related party is concerned, but on the other hand, also for the former situation the escape clause's applying only when the domestic related party is concerned falls in question, resulting from the fact that the escape clause is worded in such a way — "where…, or where…, the interest expenses actually paid to the domestic related party are entitled to be deducted…" — that both the former situation and the latter situation seem to be set with exclusive reference to the domestic related party. In my view, it is should be argued that as long as the enterprise can prove that its loan transaction with its related party keeps in line with the independent transaction, even if this related party is that abroad, the escaper clause applies. As to whether these two situations, especially the latter situation, where only the domestic related party is able to be the qualified party for the escape clause purpose constitute a different treatment

resulting in discrimination between the domestic related party and the related party abroad, I will try to answer it in the next section, namely the last but one, of present article. Moreover, it should be held that the escape clause applies to the single qualified loan transaction between the debtor enterprise and its related party, namely the per-head check, on the premise that the debt-equity ratio is exceeded under the overall check.

Next, we further explain, respectively, these two situations.

In case of the former, what should be made clear is how to prove the independence of the relevant transaction and in this respect, under Art. 114 of the Implementation Regulation, the enterprise shall provide the following information in order to prove that it has complied with the principle of independent transaction: (1) contemporaneous documentation regarding the determination standards, computation methods and explanation, etc. of the prices and expenses relevant to the business transaction with related parties; (2) the relevant information regarding the resale (or transfer) prices or ultimate sale (or transfer) prices of properties, rights to use properties and labour services, etc. involved in business transaction with related parties; (3) information of product price, pricing methods and profit levels, etc. comparable to the enterprise under investigation, to be submitted by other enterprises, which are relevant to the related party business investigation; (4) other relevant information regarding the business transactions of related party. As to loan transaction, Art. 89 of the circular No. 2/2009 further provides that the enterprise shall provide certain contemporaneous information to prove that all of the monetary value, interest rate, term, financing condition and debt-equity ratio, etc. of related debt investment are set under the principle of independent transaction in order to deduct the excess interest expenses in case the debt-equity ratio exceeds the prescribed ratio.

In case of the latter, for the taxpayers and also for the tax authorities, the

attention should be paid on the comparison of the actual tax burden between the relevant enterprises. For example, in case that whilst the debtor enterprise is a qualified High/New Tech Enterprise that enjoys the preferential rate of 15%, the domestic related party is an ordinary enterprise that is taxed at the common rate of 25%, the interests actually paid by the debtor enterprise to its domestic related party are entitled to be deducted, even if the prescribed debt-equity ratio is exceeded. Regarding the reason of this legislative setting, we can argue that in this situation, the goal of reducing the total tax burden borne by the enterprise together with its related party for the tax evasion purpose cannot come true, according to the principle of the interest expenses for one party being the interest incomes for the other party[24]. Of course, it needs to be reaffirmed that the application of this legislative setting limits to the situation where both the two parties are the domestic enterprises and the situation where the related party is the enterprise abroad still falls into the limitation of debt-equity ratio, even if the foreign country or region where this related party is located levies the enterprise income tax on this related party actually more heavily than the China does on the debtor enterprise.

## 3. Evaluation on Chinese tax regimes in terms of restriction on deduction of interest expenses

As mentioned in the starting part of present article, the tax factors that affect the decision-making of financing methods between debt financing and equity financing mainly register as two tax rules fixed in enterprise income tax, according to one of which the interest expenses on loans or debts are entitled to be deducted, but the dividends are not, and according to the other one of

[24] In fact, it should be held that in addition to avoiding excessive indebtedness of enterprises, also preventing tax evasion is the goal of Chinese lawmakers with the introduction of thin capitalization rules.

which the rate of withholding income tax applied to the interests obtained by the non-resident taxpayer is usually lower that that applied to the dividends. Therefore, the enterprises are most likely to design painstakingly the structure of financial sources by resorting to debt financing in any way that can increase loan capital, especially for group companies which the debtor and creditor belong to with the purpose of reducing the total tax burden of group companies, at least only from the tax perspective. In order to reverse this kind of distortion along with the breach of company tax financing neutrality, it is necessary to introduce some measures used to make the above tax factors weak as much as possible, among which the thin capitalization rule is a typical one. In fact, it goes without saying that the more intensive and strict the force against thin capitalization is, the better the outcome to guarantee company financing neutrality is.

Based on foregoing, I try to make an evaluation on Chinese thin capitalization rules and other relevant regimes targeting the reduction of the familiar disparity in the treatment of debt and equity. First of all, I want to give my conclusion saying that the Chinese thin capitalization rules and other relevant tax regimes targeting the limitation to the deduction of interests have a so effectively restraining impact on the enterprises' resort to debt financing beyond the reasonable limit in light of relatively high intensity these regimes are endowed with, that tax factors are not impactive enough to prevail over non-tax factors, and we can hold that to some extent, the tax neutrality in terms of company financing has been guaranteed, at least it does not give rise to a problem to be taken seriously in Chinese tax system. I reach this conclusion on the basis of the following line of reasoning:

Firstly, nearly all the kinds of enterprises fall into the scope of application of thin capitalization rules, regardless of small-sized enterprises or financial enterprises; Secondly, the scope of related debt capital to be included for the purpose of calculating the debt-equity ratio is wide, including the various

indirect debt investments, besides direct debt investments; Thirdly, the debt-equity ratio of 2 to 1 is on the low side in rate levels for the non-financial enterprises; Fourthly, the criteria according to which a subject can be considered as a related party are miscellaneous and strict; Finally, in addition to the thin capitalization rules with the high intensity the above four aspects combine to result in,[25] there are some other regimes targeting at limiting the deduction of interests, for example, the general limitation rule and the rule with respect to the non deductibility of interests in case of investment not in place.

In the end, we need to trigger an "equality test" to be added in the evaluation on Chinese tax regimes in terms of restriction on deduction of interest expenses. As such, after making a comprehensive view of the tax regimes under exam, in my opinion, the main situation worthy of debating, provided by escape clause of the Chinese thin capitalization rules, is that where when the tax burden borne by the enterprise is lighter than that borne by the domestic related party, the interest expenses actually paid to the domestic related party are entitled to be deducted from the taxable income, while the interest expenses actually paid to the related party abroad, regardless of whether the tax burden borne by the enterprise is lighter or heavier than that borne by the domestic related party, are absolutely subject to the restriction of debt-equity ratio. This legislation runs the risk of failing the "equality test". Is it really a differential treatment between the domestic enterprise and the foreign enterprise, in other words, between the resident enterprise and non-resident enterprise? Perhaps, the Chinese lawmakers would justify it on the ground that it is extremely difficult to ascertain the actual tax burden of foreign related enterprise in the foreign countries or regions, especially when the foreign related enterprise is registered in the some tax heaven, it is necessary

[25] In fact, there are still some other aspects that help to strengthen the high intensity of Chinese thin capitalization rules, for example, the re-characterization of interest as a dividend also applies to loans with a guarantee provided by related party.

to do so for the purpose of international anti-avoidance. But this kind of problem could be solved through the international cooperation and information exchange programs between the tax administrations of different counties with the participation of financial institutions. If it comes true, the above justification can still stand? Perhaps, it is necessary for the moment. Obviously, if this kind of legislation takes place in European Union, namely when the tax burden borne by debtor enterprise is lighter than that borne by its related party, the tax treatment on the interest expenses actually paid to this related party differs according to whether this related party is a domestic related party, that is a resident related party which is located in the member state where the debtor enterprise is located, or a related party abroad, that is a non-resident related party which is located in another member state: for the former, the interest expenses concerned are allowed to be deducted, but for the latter, the interest expenses concerned are not. In my view, it would be most likely to constitute a differential treatment as amounting to a discrimination involving the restriction of some freedom.

## 4. Conclusion

Although, under the influence of some more powerful non-tax factors, currently the Chinese companies in general are more of equity financing preference, the China has still stipulated a number of strict rules in tax matters in order to reduce the influence of tax factors over the financing companies and to guarantee as much as possible the company financing neutrality. In the present article, a set of Chinese rules mainly relating to the limitations on deduction of interests incurring in the course of financing is analyzed with the focus put on the financing enterprises. These Chinese rules can be divided into two sharply different categories according to whether the subject that grants

the loan or debt is the related party of the financing enterprise or not.

In case of the unrelated party, the rules relating to the deduction of interests can be further divided into two categories: when the unrelated party is the financial enterprise, interests incurred to loan or debt granted by this kind of unrelated party are fully deductible; when the unrelated party is the non-financial enterprise, interests incurred to loan or debt granted by this kind of unrelated party are partly deductible with the maximum amount calculated at interest rate of similar loan with the same term as granted by financial enterprises under the rule of general limitation.

In case of the related party, apart from the rule of general limitation, the thin capitalization rules apply and only the portion of interests not exceeding the debt-equity ratio is deductible. In fact, in light of the strictness of the definition of related relationship, the low debt-equity ratio and the wideness of the scope of subjects, the Chinese thin capitalization rules, along with other relevant tax regimes, have an effectively restraining impact on the enterprises' resort to debt financing beyond the reasonable limit. Naturally, based on the request to protect the tax interests, the China has set some rule with the different tax treatments between the domestic enterprises and foreign enterprises under the thin capitalization rules.

The tax neutrality with respect to the debt-equity choice is one of the most frequent demands in discussions about enterprise tax reforms around the world, and the China is not the exception. Instead, for the China it is necessary to launch some amendments on EITL in the area of rules relating to interests deduction, especially the thin capitalization rules in light of the role that the thin capitalization rules act as a deterrent against excessive indebtedness, in order to gain more rationality, equality and effectiveness, and finally to bring into being a proper system for capitalizing interest payments that would reduce substantially the bias in favor of debt financing over equity financing.