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Deduction of interest charged by related parties

Intercompany financing is common among the MNEs. For any borrowing from related parties, the Chinese borrowers must pay interest to them. In China, the deductibility of interest expenses charged by related parties is subject to special tax requirements.

Firstly, the arm's length principle should be followed. According to the Chinese CIT Law, for a borrowing from a non-financial company, the part of interest expense exceeding the interest rate for the same type of loans of a financial company (i.e. commercial banks, financial companies, trust companies and other financial institutions) shall not be deducted for CIT purposes. Practically, the Chinese tax authorities would refer to the interest rates published by the People's Bank of China and prefer the interest rates being set between the deposit interest rate and the loan interest rate of commercial banks. If the interest rate of the IC loan is higher than the said rate of commercial banks, the Chinese company may still enjoy the expense deduction by providing the rationality of that interest rate. Otherwise, it will be difficult for them to claim the expense deduction for the interest charges by related parties.

Secondly, the thin capitalisation rules should be complied with. The Chinese tax authorities could monitor whether or not the ratio of debt-to-equity investment that an enterprise receives from its related parties (associated liability-asset ratio) exceeds the standard ratio;

- for a financial enterprise, 5:1; or
- for any other enterprise, 2:1.

When an associated liability-asset ratio has exceeded the standard ratio, the interest expense exceeding the ratio (interest actually paid to all related parties * (1- standard ratio/ associated liability-asset ratio) will not be deductible for CIT purposes. However, the interest expenses actually paid may still be permitted for deduction, if the company is able to:

1) prove that the interests are actually paid to a domestic related party facing a higher tax rate; or
2) provide a special TP file to prove that the amount, the interest rate, the term, and financing conditions of its associated debt investments as well as its liability-assets ratio, among others, has complied with the arm's length principle. The special TP file should include:

- Analysis of the solvency and borrowing capacity of the company;
- Analysis of the borrowing capacity and financing structure of the group;
- Explanation on changes in equity investments such as the registered capital, etc;
- Nature and objective of debt investments of related parties and the market conditions when the debt investments were made;
- Currency, amount, interest rate, term and financing terms of debt investments of related parties;
- Collaterals provided and terms and conditions thereof;

- Status of guarantor and terms and conditions for guarantee;
- Interest rates and financing terms for the same type of loans in the same period;
- Terms and conditions for the conversion of convertible corporate bonds; and
- Any other materials which can prove that the arm's length principle is complied with.

Thus, for claiming a deduction for interest paid to related parties, it is crucial for companies to review in advance whether or not the interest rate of an IC loan is appropriate, and whether a special TP file can support the interest expense deduction.