Tax management: planning and compliance
Observations

1. The Chinese tax system is complex, and tax policies are changing rapidly to keep pace with economic development. At the same time, local implementation rules on tax policies warrant particular attention.

2. In addition to technical concerns and practical issues, commercial (non-tax) justifications will also be increasingly attached to tax planning and compliance.

3. Aggressive planning schemes without commercial bases tend to face more challenges. Anti-tax avoidance, including transfer pricing, is an increasing concern for tax authorities.

4. On the tax administrative side, authorities have started focusing on taxpayer services, but there is still room for improvement.

Recommendations

1. Ensure tax strategy is aligned with the overall business strategy and that tax implications are taken into account when choosing an optimal business model and transaction flows.

2. Stay on top of new tax developments and insights on tax regulations. Know the administrative practices of the local level tax bureaus.

3. Plan ahead for potential tax risks and consequences with tax risk management.
Aligning tax strategy with overall business strategy

The China tax environment may be in constant flux, but one thing is clear: tax management, both planning and compliance, are rising on the corporate agenda. Investors need to take tax laws and regulations into serious consideration and ensure that their tax strategies are aligned with overall business strategy. They need to make sure that the two complement each other. Doing this can help investors minimise tax exposure, control costs and avoid reputational risks. Software firms, for example, can be set up in China under one of several potential business models, each of which can be subject to different sets of tax policies and benefits. Investors need to understand which model is best for the business, in light of the overall business strategy, and the tax implications.

Tax and business strategies should also be aligned when a business is looking for locations in China. While some regions offer financial subsidy and/or refund in respect of taxes, other business factors should be taken into consideration, including the availability of a skilled labour force, proximity to major markets and infrastructure.

Tax reform trends and what they mean for business

Since 2008, tax reforms in China have moved forward at a steady pace, especially in the realm of corporate taxation. Foreign-invested enterprises (FIEs) and domestic-invested enterprises now apply to the same corporate tax laws and regulations in China, including the Corporate Income Tax (CIT) and other applicable taxes. Further to CIT reform, the Chinese government is rolling out a turnover tax reform, which will help reduce the multiple taxation issue associated with goods and services. On the tax administrative side, with the improvement in resources, technology and organisation systems, the Chinese tax authorities have strengthened tax administration on large and key taxpayers, non-China resident enterprises and anti-avoidance issues.
An overview of the tax administration system

Unlike common-law countries, the taxation system in China is based on law, not precedent. China’s major tax laws are passed by the People’s Congress, and regulations for implementation are formulated by the State Council. The Ministry of Finance (MoF) and the State Administration of Taxation (SAT) are then responsible for interpreting and implementing these tax laws and regulations. Finally, the branches of the local-level tax bureaus collect the tax revenue from the taxpayers, and then report back to the higher-level authorities.

Since the local level tax bureaus effectively act as “windows” for the tax authorities to interface with taxpayers and to implement the tax laws and regulations, businesses need to stay up to speed, not only on the ongoing development of laws and regulations, but also on how they are practised by their local level-tax bureaus.

Handling tax audits and disputes

Taxpayers will inevitably have to face a tax audit or investigation as part of the lifecycle of their business. These audits/investigations are carried out by independent tax audit/investigation teams at the local level or provincial tax bureaus, or even in rare cases, by state level authorities. The tax audit/investigation may be driven by issues such as the types of taxes, geography, types of taxpayers or different specific tax administration purposes. Selection criteria for these audits/investigations can touch on the taxpayer’s financial and tax position, level of sales, industry and the nationality of the parent company. Even an informant can trigger an audit.

Taxpayers may want to plan ahead for such events, by conducting a tax risk assessment on a periodical basis. That way, a business will be able to identify the areas of tax risk and have them remedied before the actual tax audit/investigation.

When handling a tax audit/investigation, the taxpayer should try to find out what the tax authorities are actually after. In order to submit the right information and documents to the authorities, the taxpayer needs to know exactly what the tax authorities’ motives are, as well as their underlying agenda, if any.

In case of a tax dispute, there is a set of appeal procedures to the higher-level tax authorities. In China, tax disputes are normally settled in this way rather than through court proceedings. Cross-border double taxation issues resulting from, say transfer pricing adjustments, however, may be resolved through Mutual Agreement Procedures between the State Administration of Taxation and the competent authority of the treaty country.
An overview of taxes for consideration

China levies a range of taxes, as follows:

**Income taxes:**
- Corporate Income Tax (CIT), including withholding income tax (WHT)
- Individual Income Tax (IIT)

**Turnover taxes and customs duty:**
- Value-added Tax (VAT)
- Business Tax (BT)
- Consumption Tax (CT)
- Customs Duty (CD)

**Property and behaviour taxes:**
- Real Estate Tax (RET)
- Urban and Township Land-use Tax (UTLT)
- Land Appreciation Tax (LAT)
- Vehicle and Vessel Tax (VVT)
- Motor Vehicle Acquisition Tax (MVAT)
- Stamp Duty (SD)
- Deed Tax (DT)
- Vessel Tonnage Tax (VTT)
- Tobacco Tax (TT)
- Arable Land Occupation Tax (ALOT)

**Miscellaneous surtaxes and local surcharges:**
- Resource Tax (RT)
- Urban Construction and Maintenance Tax (UCMT)
- Education Surcharges (ES)
- Other local surcharges

Turnover taxes and income taxes are the biggest contributors to China’s tax revenue, of which Value-added Tax represents the top source.
Taxes for consideration: income taxes, turnover taxes

The following two main forms of investment in China will have both income and turnover tax implications:

1. FIEs registered in China, and
2. Non-China resident enterprises.

**Taxes for FIEs**

Under normal conditions, foreign investors who want to set up businesses in China will opt for FIEs as their operational vehicles. FIEs, from a CIT standpoint, are “tax-resident enterprises of China.” This means they will need to use worldwide income as their CIT base for reporting purposes.

The key tax management issues of an FIE during its lifecycle can be classified into planning and compliance. Below, we’ll discuss the lifecycle for entry and operation, and then talk about corporate restructuring and their tax implications. We’ll also highlight the process of withholding individual income tax for employees, of which foreign businesses should take particular note.

**Entry**

If a foreign investor wants to inject fresh cash into China to set up a new FIE or increase the capital of an existing FIE, the cash injection is generally not subject to Chinese tax, besides stamp duties. However, should the foreign investor choose to invest in the FIE through non-cash assets, then it needs to review the CIT (and other tax) implications, taking into account the various facts and circumstances.

**Operation**

After setting up in China, an FIE will need to pay turnover tax once it comes into operation. This, of course, depends on the nature of their business and the type of products or services involved. Types of turnover taxes include:

- **Value-added tax (VAT)**, which applies to importation, production, distribution and retailing activities in respect of tangible goods and a few prescribed services. The general VAT rate is 13% or 17%. If an FIE qualifies as a general VAT payer, the input VAT that it incurs (that is, the VAT paid on goods and certain prescribed services to the suppliers) can be credited against its output VAT (that is, the VAT collected from the customers) in calculating the VAT payable. Enterprises regarded as “small businesses” are subject to a more simplified VAT calculation, which is 3% of the gross sales amount, without the input VAT credit. The export of goods from China may be entitled to a VAT exemption on the sales amount and a refund of a certain portion of the input VAT depending on the goods exported.

- **Consumption Tax (CT)** is levied on manufacturers and importers of specified categories of consumer goods that are largely luxury and non-necessity or scarce resources products. The tax liability is calculated based on the sales amount and/or the sales volume depending on the goods concerned. CT is imposed on top of the applicable VAT and CD, if applicable.

- **Business Tax (BT)** is imposed on most services provided, as long as either the provider or recipient of the services is within China. BT is also imposed on the sale of immovable property and the transfer of intangible assets in China. The rate of BT ranges from 3% to 20%, depending on the nature of the business, while the most common rate is either 3% or 5%. Limited exemptions may apply to some prescribed services. At the moment, the Chinese government is pushing forward a reform of the existing turnover tax system to gradually replace BT with VAT for industries that are currently subject to BT. From 1 January 2012, a pilot programme for turnover tax reform was formally introduced to selected industries in Shanghai and other selected cities. Depending on the effectiveness of this pilot programme, the reform may be rolled out across the country in the near future.
If an FIE engages in import or export activities, it may also be subject to customs duties. In general, customs duties are charged in either specific or ad valorem terms. For specific duty, a lump sum amount is charged based on a quantitative amount of the goods. For ad valorem duty, the customs value of the goods is multiplied by an ad valorem duty rate to arrive at the amount of duty payable. Import VAT and/or customs duties may be exempted for certain goods, machinery and equipment if certain conditions are met. Import duties are imposed on a wide range of tangible goods and some intangibles, whereas export customs duties are imposed on a few scarce resources produced in China.

The CIT liability of an FIE is calculated based on its taxable profit, multiplied by the applicable tax rate. Here are some key CIT treatments:

- The standard CIT rate is 25%. However, a lower tax rate is available for qualified small and thin-profit enterprises (20%) and for qualified new/high-technology enterprises (15%).
- There are also other tax incentives that are “predominantly industry-oriented, limited geography-based.” This is a marked shift from incentive regimes before 2008, which had tried to attract foreign direct investment over many different industries for numerous favoured geographic areas.
- Under normal conditions, an FIE should be able to deduct costs and expenditures from its taxable revenues. However, for certain prescribed expenditures, CIT deductions are not allowed, or only deductible on a certain portion of these expenses.
- If an FIE, being a tax-resident enterprise, has already paid income tax overseas (for income derived from sources outside of China – if any), then it may credit the foreign income taxes against China CIT payable. This is called the “foreign tax credit.” It is limited, however, by the amount of income tax otherwise payable in China for that non-China-sourced income.
- The branch offices of an FIE can consolidate their CIT filings with headquarters. However, there is no group relief scheme (in which group companies are considered a single company for tax purpose) for subsidiaries to make consolidated CIT filings in China.
- Tax losses can be carried forward for five years to offset future taxable income. However, tax losses cannot be carried backward.
- China’s anti-avoidance rules currently include transfer pricing rules, controlled foreign corporation rules, thin-capitalisation rules and general anti-avoidance rules. Of the above, transfer pricing has drawn the particular attention of tax authorities for the previous decade. In recent years, the Chinese tax authorities have also started paying more and more attention to other tax avoidance issues.

Investors need to take tax laws and regulations into serious consideration and ensure that their tax strategies are aligned with overall business strategy.

Matthew Mui, PwC National Tax Policy Services Partner
Corporate restructuring

FIEs may want to conduct corporate restructuring transactions within China or as part of a global or regional restructuring. For CIT purposes, the general rule of thumb is that businesses going through a corporate restructuring should recognise the gain or loss from the transfer of relevant assets and equity at a fair value, when that transaction takes place. However, if certain prescribed conditions are satisfied, the parties could opt for special tax treatment (basically, a tax deferral). But for cross-border transactions, such special tax treatments are available only for a handful of specific transactions.

In addition, VAT and/or BT may also be applicable if the transaction involves the sale of goods or assets, or the transfer of intangible assets or immovable properties. Of course, VAT and/or BT may be exempted if certain conditions are satisfied.

Withholding Individual Income Tax for employee’s employment income

As an employer, FIEs have an obligation to withhold their employees’ Individual Income Tax (IIT) on salary and wages (including bonuses and other employment-related gratuities) every month. Progressive IIT rates range from 3% to 45%, and are applicable to both local and expatriate employees, including those under secondment (or temporary transfer). IIT regulations do, however, allow for more favourable treatment for expatriate employees on deductions than for local staff. Expatriates, for example, can enjoy a deduction in their prescribed types of cost-of-living allowance. In addition, expatriate employees on short-term assignments (less than one year) have their IIT liabilities calculated based on the actual number of days residing in China, if they meet certain criteria.

1. Chinese IIT imposed not only to the employment income but also to other personal income.
Transfer pricing

China is rapidly developing its transfer pricing legislation and implementation. China requires the annual reporting of transactions between “associated enterprises”. Transfer pricing audits have also been gradually broadened in recent years to intangibles and services.

Businesses will need to deal with such audits seriously, with a designated team of tax and operational staff members assigned and a clear plan and strategy to see the audit process through. In addition, advance pricing agreements (APAs) and cost-sharing agreements (CSAs), legislated by CIT Law, could now be effective tools for reducing transfer pricing risks, as they help assure that future profit levels of Chinese subsidiaries are accepted by the Chinese tax authorities.
**Taxes for non-China resident enterprises**

Businesses that choose to do operations in China without registering an FIE are considered non-China-resident enterprises (non-TREs) for tax purpose. In general, non-TREs are also subject to tax implications in China for both passive income and active income.

**Passive income**

Examples of passive income include dividends, interests and royalties, as well as gains for equity transfers.

- **Dividends, interests and royalties**: A foreign investor’s China subsidiary (in the form of an FIE) may distribute dividends to foreign investors (shareholders), or the foreign investors may provide shareholders’ loans, technologies or other intangibles etc. to the FIE, and then require the FIE to repatriate the cash through a distribution of interests and royalty fees. In such cases, the subsidiary (FIE) will need to withhold a withholding income tax at 10% of the passive income, according to Chinese CIT regulations, before remittance.

  If the foreign investor (recipient) is a tax resident from a country or region that has signed a tax treaty with China, then the transferor (FIE) may apply for treaty benefits in respect of the dividend payments (e.g., tax exemption in China). However, the recipient and/or the FIEs will still need to go through certain procedures and prove that the recipients are the “beneficial owners” of the dividends/interests/royalties.

  On top of withholding income taxes, interests and royalties may also be subject to BT.

- **Gains on equity transfer**: At some point, a foreign investor may want to buy or set up a company in China, and then sell it sometime later to either Chinese or overseas buyers. Withholding income tax may be imposed if the investor derives a disposal gain based on fair value on the sale. There are no different tax treatments for the disposal gains in capital (investment) nature or revenue nature in China. The gains are generally subject to 10% withholding income tax. If the transferor is a tax resident of a country or region that has signed a tax treaty with China, then the transferor may apply for treaty benefits in respect of the disposal gains (e.g., tax exemption in China) if certain conditions indicated in the tax treaty are met. Even if the equity transfer of the Chinese enterprise is indirectly conducted by foreign investors, the Chinese tax authorities can still invoke general anti-tax avoidance rules to impose withholding income tax on the resulting gain, if the holding structure under certain circumstances are regarded as lacking commercial purposes.

  On the other hand, the buyer of that company should also check the deal against all relevant Chinese tax regulations since it may affect the tax basis of the acquiring enterprise and its China tax implications.

- **Exiting**: One way in which foreign investors may exit from an FIE is to reduce its capital. Capital reduction itself (excluding the recipient of dividend and/or disposal gains) is generally not subject to Chinese taxes, although getting approval for this is not exactly straightforward. Liquidating an FIE is another option. In calculating the taxable income recognised from liquidating the FIE (for CIT purposes), the entire liquidation period will be seen as one independent tax year. The remaining assets obtained by the foreign investor will be recognised as dividend income and disposal gains, respectively. They are, again, subject to a withholding income tax of 10% (or lower, where tax treaty benefits apply).

Withholding income tax rates under China’s tax treaties with other jurisdictions (as of 31 December 2011) are summarised in the Appendices of this book.

---

2. Up until the end of 2011, China has signed 97 double taxation treaties with other countries (regions).
3. See also Finance and treasury chapter on cash repatriation strategies
**Active income**

Foreign investors may be earning or deemed to earn China-sourced income via representative offices and other project-based visits. Such income is seen as active income subject to China tax, instead of passive income.

- **Representative offices:**
  
  Representative offices are set up by foreign companies in China without a separate legal entity status in China. Most representative offices in China are mainly required to pay two types of taxes, CIT and BT. There are also two ways to tax a representative office:
  
  - Based on the actual income/profit, and
  - Based on the deemed income/profit.

  On appearance, representative offices are required to report China-sourced income/profit on an actual basis, at an amount that’s equivalent to their function and risk. That is, the higher the risk and greater the function of the office, then the higher the reported profit and income should be. When the tax bureau in charge examines and determines that a representative office has failed to keep complete and accurate books or is unable to calculate and file its tax liabilities on an actual basis, the representative office may be required to file the tax on a deemed basis, which would normally be a percentage of the representative office’s income or expenses.

  In practice, however, since representative offices are not legal entities and their accounting is consolidated with overseas headquarters, it is difficult for most foreign companies to allocate the income in a way that Chinese tax authorities can verify its fairness. As a result, many representative offices in China are still required to file their CIT and BT under the deemed method. Most importantly, the deemed profit rate has increased drastically in recent years, which raises the tax cost and overall cost of doing business in China.

- **Project-based visits:** In addition to physically registering a representative office in China, foreign companies may also be able to conduct business in China by sending people to work there on a project-by-project basis. If the foreign companies provide taxable labour services in China, such services are generally subject to BT on gross service fees (subject to the upcoming tax reform). They may also be subject to CIT, depending on whether an “establishment or place” (or “permanent establishment” if the relevant tax treaty is available) is triggered. CIT may be imposed at 25% of actual profit or deemed profit. In addition, the foreign company may also have to withhold IIT for the people working in China.
Where a foreign company or an FIE chooses to hold property in China, the holding of property, including real estate, is subject to the following taxes:

- **Deed Tax**, which is applicable when receiving real property.
- **Real Estate Tax and Urban and Township Land Use Tax**, which are applicable when holding real estate.
- **Land Appreciation Tax**, which is applicable when disposing real property.
- **Vehicle and Vessel Tax**, which is levied on all vehicles and vessels registered within China according to a fixed amount per year, deadweight tonnage or weight.

Concluding dutiable documents in China is subject to **Stamp Duty** and acquiring motor vehicles is subject to **Motor Vehicle Acquisition Tax**.

**Urban Construction and Maintenance Tax** and **Education Surcharges** are applicable for entities paying VAT, BT or CT in China, and calculated at various percentages. In addition, local-level tax authorities may impose certain local surcharges, depending on the location of the entities in China.

There are also some special taxes and fees, such as **Resource Tax**, levied for taxpayers engaged in specialised industries.