

China’s Business Taxes

1 Corporate Income Tax

On March 16, 2007 Chinese lawmakers passed the Corporate Income Tax Law, unifying the tax rates for foreign and domestic enterprises. The law, which took effect January 1, 2008, brought China’s tax laws more in-line with international standards. It has unified the two existing tax codes—one for domestic enterprises, the other for foreign-invested enterprises—into one and represents a fundamental change in China’s tax policy.

The Corporate Income Tax Law contains general provisions as well as chapters on what constitutes taxable income, taxes payable, tax incentives, withholding tax at the source, special tax adjustments, administration of the levy and collection of taxes, as well as some supplementary provisions.

Corporate income tax is calculated against the net income in a financial year after deducting reasonable business costs and losses—in other words it is effectively a tax on profits. It is settled on an annual basis but is often paid quarterly with adjustments either refunded or carried forward to the next year. The final calculation is based on the year-end audit.

The income tax rate for all companies in China, both foreign and domestic, is 25%. Industry-based tax incentives exist which reward enterprises involved in the high or new technology sectors.

Tax rate	Percentage	Applicable enterprises
Standard rate	25	Most enterprises
Reduced rate	20	Small and low-profit enterprises
Withholding income tax	20	Foreign enterprises without permanent establishment in China but who derive income from China

Tax Incentives

A number of tax incentives exist:

- Qualified advanced technological service enterprises are eligible for a reduced income tax rate of 15% in 21 model cities.
- “Encouraged” high-tech enterprises are eligible for a reduced income tax rate of 15%, irrespective of the location of such enterprises in China.
- Research and development expenses can be deducted from the taxable income by 150% of the total amount.
- More tax incentives will be granted to start-up companies, and enterprises investing in environmental protection, energy and water saving, or industrial safety.
- Existing preferential tax policies for investments in infrastructure facilities, agricultural, forestry, animal husbandry and fishery industries and for those enterprises established in the western regions, have been retained.

Existing tax incentives available to those qualifying enterprises which employ laid-off or handicapped workers have been replaced with super deductions applied to the wages paid to disabled employees. For CIT, the super deduction of salary paid to disabled employees is 200%, for IIT, monthly taxes of less than RMB2000 are exempt.

Three important tax circulars were issued in February 2008 which significantly impact foreign-invested enterprises in China. These circulars further clarified several significant areas of the corporate tax regime including tax incentives for high-technology industries and grandfathering treatments.

Circular Caishui (2008) No. 1, issued February 4, 2008, specifies tax incentives available to certain industries in the tax law. It provides tax incentives to software production companies, IC production companies and security investment funds. These tax incentives mirror the incentives granted under the old tax regime. Preferential tax treatment will also continue to apply to IC production and assembly companies and software production companies newly established in the western region of China. Circular 1 also states that tax holidays for software production companies and IC production companies will start from the first profit-making year.

Grandfathering

Circular 21 clarifies how the half-rate reduction during an unutilized tax holiday period should be calculated during the grandfathering period for qualifying FIEs. Circular 21 states that the half-rate reduction during the unutilized tax holiday period should be calculated based on the gradually increased tax rates of 18, 20, 22 and 24% for the years 2008, 2009, 2010, 2011 respectively, and 25% from 2012 forward. That means the net rates will be 9, 10, 11, 12, and 12.5%, depending on the year in which the half-rate reduction applies. For FIEs that were subject to a 24 or

33% tax rate under the old tax regime, the half-rate reduction during the unutilized tax holiday period should be calculated based on 25%, making the net rate 12.5%.

Old foreign enterprise income tax	Transitional rate (%)	Transition period
15%	18	January 1, 2008
	20	January 1, 2009
	22	January 1, 2010
	24	January 1, 2011
	25	January 1, 2012

Circular Guoshuifa (2008) No. 23, released on February 23, 2008, clarifies aspects of the grandfathering treatments of previously enjoyed tax incentives. To qualify for reinvestment tax refunds, FIEs must have completed all reinvestment steps and obtained the dated business license of the new business license on or before the end of 2007.

For contracts involving interest or royalties that were entered into before 2008, have met the criteria for withholding tax under the old tax regime, and have been already approved by the tax authorities, the withholding tax exemption will continue to apply until the expiration of the original contract. This will not apply to any extension, expansion or supplementary contract of the original contract.

Foreign-invested enterprises eligible for grandfathering treatments of unutilized tax holidays will still need to observe the original requirements stipulated under the old tax law, chief among these would be business scope and operation period. If an FIE fails to fulfill the original requirements, the tax exempted or reduced period during the tax holiday, including the part falling after 2008, would be drawn back.

Representative Offices

Effective from January 1, 2010, representative offices are no longer exempt from corporate income tax, business tax and VAT in China. However, ROs may be able to acquire non-CIT status by invoking treaty protection after completing the relevant filing procedures as stipulated in Guoshuifa (2009) No. 124. Guoshuifa (2010) No. 18, issued on February 20, 2010, explicitly stipulates that ROs shall pay corporate income tax on their taxable income, as well as business tax and VAT. In accordance with the relevant laws, administrative regulations, and the State Council, ROs must provide valid accounting records. Tax authorities have the right to penalize ROs providing incomplete or incorrect records. Representative offices should also perform the principles of actual functions in matching with potential risks, and accurately calculate their taxable income—declaring to the tax authorities at least 15 days after the end of the quarter.

Representative offices are required to keep proper accounting records to ascertain their actual revenue and profits and file taxes on the same. Representative offices that cannot determine their profits on an actual basis must ascertain

their deemed tax value by either using the cost-plus method or the actual revenue deemed profit method. Under either method, the new tax circular states that the deemed profit margin shall be no less than 15%, an increase from the previous deemed profit margin of 10%.

Actual Basis Method

Representative offices should file taxes on an actual basis, based on books and records, with reported profits in line with the function of the RO.

Calculation:

$$\text{CIT} = \text{Actual taxable profit} \times \text{CIT rate}$$

$$\text{BT/VAT} = \text{Actual taxable revenue} \times \text{applicable BT/VAT rate}$$

Cost-Plus Method

This method is for representative offices that are able to accurately ascertain expenses but not revenue or cost.

Calculation:

$$\text{CIT} = \text{Deemed gross revenue} \times \text{deemed profit rate} \times \text{CIT rate}$$

$$\text{BT} = \text{Deemed gross revenue} \times \text{applicable BT rate}$$

Actual Revenue Deemed Profit Method

This method is for representative offices that are able to accurately ascertain revenue but not cost or expenses.

Calculation:

$$\text{CIT} = \text{Actual gross revenue} \times \text{deemed profit rate} \times \text{CIT rate}$$

$$\text{BT/VAT} = \text{Taxable revenue} \times \text{applicable BT/VAT rate}$$

An RO that files taxes using cost-plus or actual revenue methods may, after filing with the in-charge tax authority, switch to the actual basis provided that it can maintain complete accounting books, and accurately calculate its taxable revenue, profit and tax liabilities.

Dealing with Non-compliance

Firstly, if you have not been conducting filing, is this because you were exempt or did it just get overlooked? A quick license check will tell the story. If you have not

filed, did you ever register? Again, a look at your tax registration certificate will show if you did. This is potentially now two problems—lack of registration, and lack of filing.

If you never registered for tax, you will need to. Beforehand, you will need to prepare a full set of accounts backdated to the day you begun operations. You should then go to the tax bureau and own up. They may well look somewhat dimly at you, and mutter threats of “five times amount due” to you. Do not attempt to negotiate with them—you have no right to do so. Instead this is a time to be meek and mild, and above all compliant. They may well ask you to submit your accounts for audit, and you will need to hire a professional firm to arrange this for you. Go back with the audited accounts, register for tax, and then see what they have to say about the tax assessment over what is due.

For businesses, it is common when non-registration has occurred for the original business license to be out of date in other ways—maybe change of address or of chief representative. It makes sense to get all of these issues addresses at the same time—so check for other licensing inconsistencies while you are about it.

This is a bit easier to deal with if at least you did register for tax—but you will still need to go cap in hand to the tax bureau with a set of prepared accounts and say “sorry.” This may also need to be audited for previous years, so you will need to arrange to get this done. Again, up to five times the amount due can be levied.

In terms of dealing with the bureau, it is you that is not in compliance—not they who need to be in compliance with you. You are going to get a bill, certainly for the amount of tax that is due. So go armed with a proper set of accounts and then be prepared for an audit request. This will almost certainly mean you need to see a professional firm, but this is not a time to skimp on fees. You have already caused the tax bureau grief in non-compliance so make it easier for them.

Be pleasant, non-confrontational and do not argue. Do not attempt to give them any presents. If you are seen to be penitent and to have a legitimate desire to pay and comply in future, they are more likely to be lenient with you, and maybe not even levy any late payment penalties. However, it is wise to approach the tax bureau having already fixed the problem and being able to provide revised accounts—it makes sense to get in professional advise to ascertain exactly what needs to be done to rectify the situation, have them conduct this work—and then approach the tax bureau with both the problem, the solution, and the overdue tax payment all in one go. It makes their life easier and they are more likely to be lenient with you. This scenario applies just as much to companies in China as it does individuals.

2 Withholding Tax

Withholding tax is a PRC tax levied on overseas companies providing services to China-based businesses.

For companies based outside of China but who are supplying services to clients in China (this can include a China-based subsidiary), your invoices are in effect “China-derived income” and the Chinese tax authorities levies taxes on these amounts. These are withheld by your client in China, being deducted from your gross invoice amount. This is why many overseas companies without a legal presence in China cannot receive the total gross amount due on their invoices to the China entity.

Your client has the responsibility of passing this tax onto the tax bureau. If they do not, or do not subtract the relevant amount of tax from your invoice, then the Chinese tax bureau will pursue the local business—and not the overseas operation—for settlement.

The withholding income tax rate for non-tax resident enterprises in China for passive income is 20% under the CIT law. This was reduced to 10% under the detailed implementation regulations of the CIT law. From January 1, 2008, this rate shall be applied to the dividends that a non-resident company receives from a resident company, unless otherwise prescribed in the tax treaty with the relevant foreign government. If the rate in the tax treaty is higher than 10%, 10% of dividends shall be adopted according to current rules; if the rate in the tax treaty is lower than 10%, the rate in the tax treaty should be adopted.

Tax rate on dividends from tax treaties

Tax rate (%)	Countries (regions)
0	Georgia (If the beneficial owner holds directly or indirectly at least 50% of the capital of the company paying the dividends and the total investment is no less than EUR2 million)
5	Kuwait, Mongolia, Mauritius, Slovenia, Jamaica, Yugoslavia, Sudan, Laos, South Africa, Croatia, Macedonia, Seychelles, Barbados, Oman, Bahrain, Saudi Arabia, Ethiopia
5 (holds directly 10% of the capital of the company paying the dividends)	Venezuela, Georgia (investment in the company paying the dividends is no less than EUR100,000; 10% of gross dividends if the beneficial owner holds directly less than 10% of the capital of the company paying the dividends)
5 (holds directly 25% of the capital of the company paying the dividends)	Algeria, Luxembourg, Korea, Ukraine, Armenia, Iceland, Lithuania, Latvia, Estonia, Ireland, Moldova, Cuba, Trinidad and Tobago, Tajikistan, Hong Kong, Macau, Singapore (10% of gross dividends if the beneficial owner holds directly less than 25% of the capital of the company paying the dividends)
7	United Arab Emirates
7 (holds directly 25% of the capital of the company paying the dividends)	Austria (10% of gross dividends if the beneficial owner holds directly less than 25% of the capital of the company paying the dividends)
8	Egypt, Tunisia, Mexico
10	In all other cases

China has tightened its policies and procedures regarding withholding tax from non-tax resident enterprises for their China-sourced income. Non-resident enterprises with or without establishment or place in China, and those with income not effectively connected with such establishment or place, shall pay CIT on their China-sourced income. Such income includes: income from the sales of goods; income from the provision of services; income from the transfer of property, dividends and profit distribution; income from equity investment, interests, rentals, royalties; income from donation; and any other income not included in the categories listed.

The income tax payable on such income derived by non-resident enterprises shall be withheld at source, and the payer shall be the withholding agent. The withholding agent shall withhold tax from the amount of each payment that is paid or that becomes due at the time of payment or at the time the payment falls due, which means that the withholding obligation arises when such income is remitted or when the payer accrues the amount as a cost or expense under the accrual method of accounting, and the China enterprise who remits the fund overseas shall be the withholding agent. Calculation of tax liability:

$$\text{Withholding tax payable} = \text{taxable income} \times \text{tax rate}$$

For dividends, interest, rental and royalty income, the taxable amount is the gross amount remitted before deduction of any taxes, including business tax. If the withholding tax and business tax is borne by the payer, the amount of income should be grossed up to arrive at the taxable income. For dividends paid overseas, no business tax is levied. For income from the transfer of property, the taxable income amount shall be the balance of the total income amount less the net value of the property. For other income, the taxable income amount shall be calculated according to the approaches as mentioned in the preceding two items.

Administration of Withholding Tax

Non-resident enterprises subject to withholding tax in China and the China withholding agents are strongly advised to comply with the procedures to avoid potential penalties. The procedures are applied to a non-resident enterprise's China sourced dividend, interest, rental and royalty income, and income from transfer of property. The filing procedure is fairly straight forward. A copy of the contract giving rise to taxable income, along with a contract registration record for withholding income tax and other relevant documents must be submitted to the in-charge tax bureau within 30 days of signing the contract.

This procedure also applies to each subsequent revision, supplementation or extension of the contract. All documentation, including those originally in a foreign language, must be translated into Chinese. If an equity transfer is between two non-Chinese parties and the transaction takes place outside China, the resident enterprise whose equity is exchanged should file a copy of the share transfer

agreement when applying for a change of its tax registration. The seller of the equity should report its taxes on its own or by appointing an agent.

The tax will be withheld from the cash payment by the payer and within 7 days from the payment date, the withholding agent shall pay the amount withheld on each payment to the state treasury and submit the withholding return to local tax authorities. In the case the income is paid by installment, the withholding agent should, within 15 days before making the last payment, report to the tax bureau in charge the details of all payments already paid, together with previous withholding returns and tax payment evidence, to complete a tax withholding clearance.

The China withholding agent should maintain books and records for taxes withheld and a file of the relevant contracts, which will be subject to inspection by tax bureaus.

If the withholding agent fails to fulfill its obligation to withhold tax, non-resident enterprises shall file and pay corporate income tax to the local tax authorities where the income is derived from within 7 days of the due date for tax filing and payment.

3 Value-Added Tax

China's value-added taxes contribute a large percentage of China's annual tax revenue and account for a significant proportion of tax liabilities for many Chinese enterprises. They affect companies that sell, manufacture, process or repair tangible goods in China and can be quite complex.

In China, VAT is administered by the State Administration of Taxation (import VAT is collected by Customs on behalf of SAT), and the tax revenue, except import VAT, is shared between the central government (75%) and local governments (25%). VAT is the major source of fiscal revenue for the government of China, particularly the central government. In 2009, the revenue from VAT amounted to RMB1.84 trillion, accounting for 31% of China's total tax revenue for the year, the largest percentage of the China's annual tax revenues (see table in [Chap. 1](#)).

China started to implement VAT in 1984 on 24 specified taxable items. On December 13, 1993, the State Council promulgated the Interim Regulation of the People's Republic of China on Value Added Tax (VAT Interim Regulations) with the intent of "unifying taxation management, equalizing the tax burden, simplifying the tax system, and guaranteeing financial revenue." This law codified China's VAT system and continued to be in use until November 2008.

In 2004, China introduced VAT reforms in the provinces of Heilongjiang, Jilin and Liaoning in an effort to revitalize the old industrial base of Northeast China. The method of "increment deduction" was adopted and the scope of the reform was confined to eight industries: equipment manufacturing, petrochemical, metallurgy, automobile, shipbuilding, new- and high-tech industries, and agricultural products processing. Following the success of the pilot reform in the Northeast, it

was extended in 2007 to 26 old industrial base cities in the Central Chinese provinces of Henan, Hunan, Hubei, Shanxi, Anhui and Jiangxi. In the second half of 2008, five areas of eastern Inner Mongolia and the earthquake-devastated region of Wenchuan in Sichuan Province were also designated as VAT reform pilot areas. In 2009 the central government implemented the VAT reforms nationally.

VAT Reform

On November 10, 2008, the State Council of China approved the amendments to the VAT Regulations, which took effect in the beginning of 2009. The key change is a shift from a production-based VAT regime to a consumption-based one. With the exception of specific industries that the state has mandated are to be restricted, all industries in China now fall under the VAT reform system and companies are able to offset the full amount of input VAT paid on newly purchased machinery and equipment against VAT collected when they sell their products.

The main changes to the amended VAT Interim Regulations are as follows:

- Full VAT credit on fixed assets, but VAT-In paid on consumer goods used by taxpayers themselves (for example, cars and yachts) cannot be creditable.
- The VAT rate for small scale taxpayers was reduced to 3% from 4 or 6%.
- Cancellation of VAT exemption policy on imported equipment for companies in “encouraged” industries.
- Cancellation of VAT refund policy on purchasing domestically manufactured equipment for companies in “encouraged” industries.
- Cancellation of VAT exemption policy on imported equipment for contract processing, assembly or compensation trade.

This is good news for most companies because the measures are expected to reduce the tax burden on companies. However, please be aware that this change could adversely affect cash flow in companies in “encouraged” industries as the aforementioned VAT exemption policies have been abolished. VAT exemptions on imported equipment are now gone and companies will need to increase fund reserves to pay for VAT in advance.

They may also lack sufficient VAT-Out to absorb VAT-In credit (explained in detail below) on fixed assets if they export all or most of their products. The VAT reform also presents an additional tax burden for R&D centers that imported equipment on a tax-free basis in the past. They now have to pay VAT on imported equipment under the new VAT regulation and are not able to claim any credit against their business tax liability. Companies engaged in transfer sales with local customers should note that the VAT-In paid on imported equipment cannot be refunded. In another words, it will be an additional cost under the current VAT system.

Companies may consider setting up new entities in bonded zone to alleviate the impact on cash flow as well as tax burdens arising from the cancellation of preferential VAT exemption on imported equipment imported into bonded zones.

VAT Rates

The Chinese government rules that all enterprises and individuals engaged in the sale of goods, provision of processing, repairs and replacement services, and import of goods within China shall pay VAT. There are a few exemptions, such as self-produced agricultural products sold by agricultural producers, contraceptive medicines and devices, antique books, importation of instruments and equipment directly used in scientific research, experiment and education, importation of materials and equipment from foreign governments and international organizations as assistance free of charge, articles imported directly by organizations of the disabled for special use by the disabled, and sale of goods which have been used by the sellers. However, pretty much every business will be liable for this tax.

For the sale of goods or taxable services, VAT is incurred on the date when the sales sum is received, or documented evidence of the right to collect the sales sum is obtained. For imported goods, it is incurred on the date of import declaration.

VAT on imported goods is collected by Customs on behalf of the tax authorities. VAT on articles for personal use brought or mailed into China by individuals is levied at the same time as customs duty.

VAT taxpayers are divided into general taxpayers and small-scale taxpayers, and their respective tax obligations are elaborated below.

General Taxpayer Status

According to the Measures for the Administration of the Qualification Recognition of VAT General Taxpayers enacted on February 10, 2010, taxpayers with an annual sales value not exceeding the level for small-scale taxpayers set by MOF and SAT as well as taxpayers who have newly established their business may apply to the tax department for recognition as general taxpayers.

However, full general taxpayer status is not instantly granted to wholesalers. Only after passing a 3-month trial testing period as a general taxpayer under a tax officer's supervision can the wholesaler become a fully certified general taxpayer.

Taxable items	Rate (%)
Exportation of goods (except where otherwise stipulated by the state)	0
Cereals and edible vegetable oils; tap water, heating, cooling, hot air supplying, hot water, coal gas, liquefied petroleum gas, natural gas, methane gas, coal/charcoal products for household use; books, newspapers, magazines (excluding the newspapers and magazines distributed by the post department); feeds, chemical fertilizers, agricultural chemicals, agricultural machinery and plastic covering film for farming; agriculture, forestry, products of animal husbandry, aquatic products; audio-visual products; electronic publications; dimethyl ether; edible salt	13
The import and sales of goods other than those listed above; services of processing, repairs and replacement	17

VAT Calculation for General Taxpayers

The VAT rate for general taxpayers is generally 17%, or 13% for some goods (see table above). For taxpayers who deal in goods or provide taxable services with different tax rates, the sale amounts for the different tax rates shall be accounted for separately. If this is not done, the higher tax rate shall apply.

VAT payable relies on two figures: output VAT and input VAT. Output VAT is that payable on the services and goods sold by a company, namely: output VAT = $A \times B$, where A = sales value and B = tax rate. Input VAT is that payable on the goods and services a company buys from another supplier.

The input VAT is used as a credit against the output tax levied on selling the goods. The VAT payable shall be the output VAT for the period, after deducting the input VAT for the period, i.e.:

$$\text{VAT payable} = \text{output VAT} - \text{input VAT}$$

VAT Calculation for Small Scale Taxpayers

From January 1, 2009, the VAT thresholds for those enterprises that do not qualify for general taxpayer status have been amended. First, the sales threshold for small scale taxpayers has been reduced from RMB1 million (for enterprises engaged primarily in the production of goods or the provision of taxable services) and RMB1.8 million (for enterprises engaged in the wholesaling or retailing of goods) to RMB500,000 and RMB800,000, respectively. And second, non-enterprise units and entities that normally do not engage in taxable activities are given the choice whether or not they are taxed as small-scale taxpayers while individual (natural person) taxpayers with business turnover exceeding the threshold shall continue to be taxed as small-scale taxpayers. The current VAT rate for small scale taxpayers is 3%. As such taxpayers cannot deduct input VAT, the formula is as follows:

$$\text{VAT payable} = \text{sales value} \times \text{tax rate (i.e., 3\%)}$$

Export Tax Rebates

Since 1985, China has had in place a tax rebate system designed to support export trade and increase the international competitiveness of companies involved in this business.

Over the past years, Chinese government has been actively discouraging the development of industries which consume high amounts of energy and natural-resources or those that pollute the environment to a great extent by lowering the export refund rates applicable to the relevant products and prohibiting the use of processing trade models.

With China's trade surplus growing rapidly, the central government has made significant changes to its VAT refund system in an attempt to slow export growth. Because of the ongoing changes to the system, export tax rebates and exemptions have now become a major cause for concern among most foreign enterprises.

As the world financial crisis took hold, the central government moved to increase the VAT refund rates on several industries in an effort to boost production. For example, China has increased the tax rebate on textiles at least four times in 2009. In October, 2009, the Ministry of Finance raised export tax rebates on 2,486 different types of products, an estimated one-quarter of all exports listed by Chinese customs authorities. However, there has been a steady recovery in import/exports since 2010. In June 2010, the trend of increasing export rebate rates was reversed when the Ministry of Finance cancelled the export tax rebates for 406 products, mainly high pollution, high energy consumption products.

So exactly who qualifies for export tax rebates? There are two important concepts to understand; the "exemption, deduction and refund" method, and the "maximum refundable amount."

The exemption, deduction and refund method and formula is generally applicable only to production enterprises qualified as general taxpayers (as noted above, there is no refund for small scale taxpayers), which are either directly engaged in export or which consign goods to other import and export enterprises for export.

Exemption, deduction and refund are defined as:

- Exemption—goods which are exported by production enterprises either directly or on consignment through foreign trade companies are exempt from VAT-Out.
- Deduction—applies to enterprises whose self-produced goods are both exported (directly or through export agents) and sold domestically. The VAT-In credit on materials purchased for the production of export goods is offset against the VAT-Out on domestic sales.
- Refund—applies if there is excess input VAT above that amount retained for credit (to be carried forward).

Exemption, deduction and refund calculation:

$$\begin{aligned} \text{VAT payable} &= \text{VAT-Out} - \text{VAT-In} + \text{non-refundable VAT} \\ &\quad - \text{VAT-In brought forward from previous period} \end{aligned}$$

$$\begin{aligned} \text{Non-refundable VAT} &= (\text{export-imported free duty raw materials}) \\ &\quad \times (\text{levy rate-refund rate}) \end{aligned}$$

If VAT payable is a positive figure, then the enterprise will have to pay VAT to the tax bureau, if it is negative, then the tax bureau will refund the enterprise.

Maximum refundable amount calculation:

$$\text{Maximum refundable amount} = (\text{collection amount from overseas for the export sales} - \text{free duty imported raw material}) \times \text{refund rate}$$

If the absolute value of VAT payable is less than the maximum refund amount, the refund amount equals the absolute value of VAT payable. If the absolute value of VAT payable is greater than the maximum refund amount, then the refund amount equals the maximum refund amount (the balance between the absolute value of VAT payable and maximum refund amount will be carried forward to the next period).

Example Assumptions for the example are shown in the following table (in this case, we assume there is no custom duty applied).

Local purchased raw material price	300
Imported raw material price	50
Local sales price	100
Export sales price (assuming the collection has been received in current month)	400
Levy rate	17%
Refund rate	13%

Let us suppose that one-fifth of imported raw material is used for local sales based on the proportion of local sales out of total sales. The calculation of the refund amount is:

Calculation		
VAT-Out	$100 \times 17\%$	17
VAT-In	$300 \times 17\% + 50 \times (1/5) \times 17\%$	52.7
Non-refundable	$(400 - 50 \times (4/5)) \times (17 - 13\%)$	14.4
VAT payable	$(17 - 52.7) + 14.4$	-21.3
Maximum refund amount	$(400 - 50 \times (4/5)) \times 13\%$	46.8

As the absolute VAT payable is less than the maximum refund amount, the tax bureau will refund RMB21.3 to the enterprise. Note that no VAT or customs duty is levied on imported raw material used for export sales only if a company uses the Customs Handbook for importing and exporting; for imported raw material used for local sales, VAT and customs duty apply.

Profit and loss for the above case	RMB
Sales	500
Cost of raw material	350
Non-refundable VAT	14.4
Gross margin	135.6

Since the refund rate is different from the levy rate, export-oriented enterprises shall bear additional tax burdens, which ultimately will affect profit and loss.

Export Tax Rebate and Exemption Declaration Procedures

Export enterprises must follow up formal registration of tax refund to apply for a VAT refund or exemption. They should submit the following documentation to the responsible tax authority for the approval of registration, which should be obtained within 30 days from the date of export approval:

- Declaration form.
- Business license.
- Ministry of Commerce documentation approving export operation.

After a production enterprise carries out export procedures and records the sales in their financial statement—based on the requirements of their accounting system—it can apply to the tax bureau for VAT payment and exemption and deduction, and to the same bureau for VAT refunds.

The application period for a tax refund is from the 1st until the 15th of the following month. When an enterprise applies for a VAT payment and exemption or deduction, the following documentation needs to be provided:

- Declaration of VAT payment form and other required forms.
- Summary declaration form of VAT exemption, deduction and refund for production enterprise, issued and approved by the local tax refund authority.
- Export invoice, import and export declaration form, export proceed cancellation and verification from the State Administration of Foreign Exchange.
- Other documents as may be required by the tax authority.

For newly incorporated manufacturing companies, accumulated negative VAT payable for the first 12 months cannot be refunded—this amount will be refunded in the 13th month in one lump sum. If the company cannot collect money from overseas customers for the export sales, it also cannot obtain a refund on time. If the company cannot complete the VAT effective date of registration filing for export sales within 90 days (for example: the goods are shipped outside of China and the export declaration form obtained in January, but the VAT effective date of registration filing is not completed prior to the end of March), these export sales must be deemed as the local sales, and are liable for 17% VAT.

4 Business Tax

This is a tax payable against turnover by all enterprises and individuals undertaking the following business: providing taxable services, including communications, transport, construction, finance and insurance, telecoms, culture, entertainment and service industries; transferring the provision of intangible assets; and selling immovable properties.

The basic formula is:

$$\text{Tax payable} = \text{turnover} \times \text{tax rate}$$

Only a very few items are excluded from turnover

Rates of business tax vary considerably, dependent on industry.

Business tax rates

Industry	Tax rate (%)
Transportation	3
Construction	3
Finance and insurance	5
Post and telecommunications	3
Culture and sports	3
Entertainment	5–20
Servicing agencies	5
Transfer of intangible assets	5
Sales of immovable properties	5

The Ministry of Finance and State Administration of Taxation jointly issued revised Implementation Rules for Provisional Business Tax Regulations on December 15, 2008, making some fundamental changes to the taxing principals of the business tax regulations. The revised rules took effect January 1, 2009.

Under the old business tax rules, the service providers were only liable to business tax in China if the taxable service was rendered within China. Thus when a foreign enterprise provided services to China clients and such services were conducted outside China, the foreign enterprise would not be subject to business tax in China. However, under the new rules, the definition of taxable services subject to business tax has been expanded to include services performed where either the service provider or the service recipient is located in China, without regard to where the service is actually been rendered. Therefore, as long as the service provider or service recipient is located in China, the service will be taxable for business tax purposes, regardless of being onshore or off shore. The only exclusion is where both service provider and service recipient are located outside China.

Financial institutions used to be subject to business tax on the trading of foreign exchange, marketable securities and futures, but non-financial institutions and individuals were not. Under the new regime, the trading of foreign currency, marketable securities, non-commodity futures and other financial commodities by any taxpayer are subject to business tax.

Formerly, deemed sales applied only to a company transferring immovable property to other parties without any consideration, however under the new rules, deemed sales apply to either a company or an individual transferring immovable property or land use rights to other companies or individuals without any consideration.

The changes in China's business tax rules have increased the amount of tax paid by multinational service providers with clients in China (see chart below). Service

providers should consider modifying billing arrangements with Chinese clients by charging business tax from Chinese clients or arranging for an overseas office to bill and collect payment from their Chinese client's international affiliates if possible.

Scenario	Service provider	Service recipient	Service provided in China	Service provided outside China	Business taxpayer
Before January 1, 2009					
A	In China	Outside China	Business taxable	Non-business taxable	In China service provider
B	Outside China	In China	Business taxable	Non-business taxable	Outside China service provider
C	In China	In China	Business taxable	Non-business taxable	In China service provider
D	Outside China	Outside China	Business taxable	Non-business taxable	Outside China service provider

Scenario	Service provider	Service recipient	Service provided onshore China	Service provided offshore China	Business taxpayer
After January 1, 2009					
A	In China	Outside China	Business taxable	Business taxable	In China service provider
B	Outside China	In China	Business taxable	Business taxable	Outside China service provider
C	In China	In China	Business taxable	Business taxable	In China service provider
D	Outside China	Outside China	Non-business taxable	Non-business taxable	N/A

Business tax is usually calculated, filed and paid to the local tax bureau every month.

When first registering for business tax, the tax bureau will issue a form showing all the taxes applicable. Businesses must be careful if they are selling goods and services simultaneously, as in these cases there are complicated criteria to judge whether business tax or VAT is applicable. Professional advice is recommended.

5 Consumption Tax

The current consumption tax system was introduced in 1994 along with the nationwide indirect taxes reform, including VAT and business tax. Consumption tax is levied on five categories of products:

1. Products the overconsumption of which is harmful to health, social order and the environment, e.g., tobacco, alcohol, firecrackers and fireworks.
2. Luxury goods and non-necessities, such as precious jewelry and cosmetics.

3. High-energy consumption and high-end products, such as passenger cars and motorcycles.
4. Non-renewable and non-replaceable petroleum products, such as gasoline and diesel oil.
5. Financially significant products such as motor vehicle tires.

This tax applies whenever certain luxury or other goods are manufactured, processed or imported. Consumption tax is levied only once. Tax rates vary considerably with the product and the tax paid is computed directly as a cost and cannot be refunded (except in rare cases upon the receipt of a consumption tax special invoice from the domestic supplier for consumption taxes paid for export goods). In addition, consumption tax is part of the base upon which VAT is levied. Be careful if you are processing taxable goods for others, since you are liable to withhold and pay consumption tax based on the value of the raw material and your processing fee. Consumption tax should be filed and paid monthly.

Consumption tax rates

Taxable items	Tax rate	Comments
Tobacco		
Grade A cigarettes	56% or RMB150 per box (250 cartons)	Includes imported
Grade B cigarettes	36% or RMB150 per box (250 cartons)	Includes imported
Cigars	36%	
Cut tobacco	30%	
Alcohol		
White spirits	20% plus RMB0.5 per 500 g/ml	Plus RMB0.5 per 500 g/ml
Yellow spirits	RMB240/ton	
Beer	Type A: RMB250/ton Type B: RMB220/ton	
Other alcoholic drinks	10%	
Alcohol	5%	
Precious jewelry and precious jade and stones	Gold, silver, platinum and diamond: 5% Other precious jewelry and precious jade and stones: 10%	Includes all kinds of gold, silver, jewelry and precious stone ornaments
Firecrackers and fireworks	15%	
Gasoline		
	Leaded: RMB1.4/l Unleaded: RMB1.0/l	
Diesel oil		
	RMB0.8/l	
Passenger cars, with a cylinder capacity of 1.5 l and below	1 l and below: 1% 1–1.5 l: 3%	
1.5–2 l	5%	
2–2.5 l	9%	
2.5–3 l	12%	

(continued)

(continued)

Taxable items	Tax rate	Comments
3–4 l	25%	
Above 4 l	40%	
Small-to-medium size commercial vehicle (e.g. cross country vehicles, minibuses and vans)	5%	
Motorcycles, with a cylinder capacity of		
250 ml below	3%	
Over 250 ml	10%	
Motor vehicle tires	3%	Radial tire exempt
Cosmetics	30%	Luxurious skin-care products are classified as “cosmetics” and are subject to consumption tax at 30%
Golf balls and equipment	10%	
Luxury watches	20%	
Yachts	10%	
Disposable wooden chopsticks	5%	
Solid wood flooring	5%	
Naphtha	RMB1.0/l	
Solvent oil	RMB1.0/l	
Lubricating oil	RMB1.0/l	
Fuel oil	RMB0.8/l	
Aviation oil	RMB0.8/l	Temporary exemption

6 Other Specialist and Smaller Applicable Taxes

Urban Construction and Maintenance Taxes (UCMT) and Education Surcharge (ES)

Urban Construction and Maintenance Tax (UCMT) and Education Surcharge (ES) were originally enacted by the State Council in 1985 and 1986, respectively. Circulars were subsequently issued exempting foreign-invested enterprises, foreign enterprises and foreign individuals from these two surtaxes. On October 18, 2010, the Notice of the State Council on Unifying the Collection of UCMT and ES on Domestic and Foreign-Invested Enterprises and Individuals was issued, abolishing previous circulars exempting foreign entities from UCMT and ES tax liability. As a result, FIEs, FEs and foreign individuals are now subject to the two surtaxes.

The UCMT rates are 7% for urban areas, 5% for counties (towns), and 1% for other regions, while the ES rate is 3% regardless of location.

The UCMT and ES amounts payable are the total turnover tax liability (including VAT, Business Tax and Consumption Tax) multiplied by the corresponding tax rates.

Example calculation:
A company in the urban area of Beijing is subject to VAT of RMB 50 and Business Tax of RMB 50.
Total turnover tax liability:

$$\text{RMB 50 VAT} + \text{RMB 50 BT} = \text{RMB 100}$$

Tax rate of the surtaxes:
 $3\% \text{ ES} + 7\% \text{ UCMT} = 10\%$

Total surtax:
 $\text{RMB } 100 \times (7\% + 3\%) = \text{RMB } 10$

Total tax liability (inclusive of the two surtaxes):
 $\text{RMB } 100 + \text{RMB } 10 = \text{RMB } 110$

Resource Tax

Companies or individuals engaged in the exploitation of mineral resources or salt production are liable for resource tax.

Item	Rate
Crude oil	RMB8–RMB30 per ton
Natural gas	RMB2–RMB15 per 1,000 cubic meters
Coal	RMB0.3–RMB5 per ton
Other non-metal ores	RMB0.5–RMB20 per ton or cubic meter
Ferrous metal ores	RMB2–RMB30 per ton
Non-ferrous metal ores	RMB0.4–RMB30 per ton
Salt	RMB2–RMB10 per ton (liquid) RMB2–RMB60 per ton (solid)

The formula is:
Tax payable = quantity of taxable products × applicable tax amount per unit

Land Appreciation Tax

This is paid by enterprises, units, individual household businesses and other individuals who receive income from the transfer of state-owned land use rights, buildings and their attached facilities.

The tax is based on the amount of appreciation, i.e. the balance of proceeds received by the taxpayer on the transfer of real estate after deducting the sum of deductible items as prescribed in the Interim Regulations of the PRC on Land Appreciation Tax.

Based on the percentage of the appreciation amount over the sum of the deductible items, the tax is levied progressively according to a four-level tax rate schedule as follows:

Grade	Appreciation/deduction (%)	Tax rate (%)	Quick deduction (%)
1	≤50	30	0
2	>50 and ≤100	40	5
3	>100 and ≤200	50	15
4	>200	60	35

The amount of tax payable shall be calculated respectively for each portion of the appreciation by applying the applicable tax rates in line with the percentages of the appreciation amount over the sum of the deductible items. The sum of the amount of tax payable for different parts of the appreciation shall be the full amount of tax payable by the taxpayers.

The formula is:

$$\begin{aligned} \text{Tax payable} &= (\text{appreciation} \times \text{tax rate}) \\ &\quad - (\text{sum of deductible items} \times \text{quick deduction}) \end{aligned}$$

The tax is payable except in situations where the appreciation amount on the sale of ordinary standard residential buildings construction does not exceed 20% of the sum of deductible items, and when the real estate is taken over or repossessed in accordance to the laws related to the construction requirements of the state.

Property Tax

From January 1, 2009, foreign-invested enterprises, foreign enterprises and organizations and foreign individuals have to pay the real estate tax in accordance with the Interim Regulation of the People's Republic of China on Real Estate Tax.

At present, this tax is only applied to enterprises with foreign investment, foreign enterprises and foreigners, and levied on residential property only. Taxpayers are owners, mortgagees, custodians and users of such properties.

The tax is calculated on the residual following the subtraction of between 10 and 30% of the original value of the property. Details of the scope of the subtraction are determined by provincial government, autonomous region or municipality directly under the central government. Should the property's original value not be available as a basis, the local tax organ will examine and decide on an amount with reference to the value of other real estate of a similar nature. Where the property is leased, the rental income from the property will be used as a basis for tax calculations.

The tax is calculated on the residual value of the property at a rate of 1.2%. Rental income from the property is calculated at a rate of 12%.

Vehicle and Vessel Usage License Plate Tax

The Interim Regulations of the People’s Republic of China Concerning Vehicle and Vessel Tax went into effect as of January 1, 2007.

Schedule of the tax items and tax amount of vehicle and vessel tax

Tax unit	Tax item	Annual tax amount	Note
Passenger automobile	Per vehicle	RMB60–RMB660	Including trolley
Cargo automobile	Per ton of its dead weight	RMB16–RMB120	Including tractor-truck and trailer
Three-wheeled and Low-speed truck	Per ton of its dead weight	RMB24–RMB120	
Motor vehicle	Per vehicle	RMB36–RMB180	
Vessel	Per ton of its net tonnage	RMB3–RMB6	The tax amount of tugboat or non-motor barge shall be paid at 50% of that of vessel

The formula is:

$\text{Tax payable} = \text{quantity (or net-tonnage) of taxable vehicles} \times \text{applicable tax amount per unit}$

$\text{Tax payable} = \text{net-tonnage (or deadweight tonnage) of taxable vessels} \times \text{applicable tax amount per unit}$

Tax exemptions may be given on diplomatic vehicles and vessels.

Stamp Tax

Those liable for stamp tax include any enterprise, unit, individual household business operators and other individual who executes or receives specified documents.

Taxable items	Rate (%)
Purchase/sale contracts	0.03
Processing contracts	0.05
Survey and design contracts for engineering and construction projects	0.05
Construction installation and engineering contracts	0.03
Property, leasing contracts	0.10
Goods transportation contracts	0.05
Warehousing contracts	0.10
Loans contracts	0.005
Property insurance contracts	0.10
Technology contracts	0.03
Property title transfer documents	0.05
Business accounting documents—capital recording documents; other accounting documents	0.05; RMB5/piece
Permits and licenses	RMB5/piece
Stock exchange	0.10 (paid by transferees only)

The formulas for computation are:

$$\text{Tax payable} = \text{amount of payment (or fees, receipt) indicated in taxable documents} \times \text{applicable rate}$$

$$\text{Tax payable} = \text{number of pieces of taxable documents} \times \text{tax amount per unit}$$

Tax exemptions may be granted on duplicates or copies of documents on which the stamp tax has already been paid; some documents related to charities etc.; non-interest bearing or discounting loan contracts; preferential loan contracts concluded between foreign governments or international financial institutions and the Chinese government or state financial institutions; and insurance contracts for agriculture and forestry products and animal husbandry.

Deed Tax

Those liable are enterprises, units, individual household businesses and other individuals who are the transferees of residential property.

Deed tax is normally based on one of the following: the transactional price of the sale or purchase of residential property, sale of land use rights, or lease of use rights of state-owned land; the market price of land use rights or residential property transferred as gift or inheritance as assessed by tax officials; and the price difference in the exchange of land use rights and residential property.

Deed tax is applied at a flat rate between 3 and 5%. The rate applicable is determined at provincial level.

The formula is:

$$\text{Tax payable} = \text{tax base} \times \text{applicable rate}$$

Exemptions may be granted in cases such as state-owned residential properties purchased for the first time by employees; the use rights of barren mountains, barren gullies, barren hills and/or barren beaches received for use in agriculture, forestry, animal husbandry and fishery industry; diplomatic organizations and staff; and residential properties purchased as a result of residential property loss due to force majeure (such as natural river flooding or earthquakes).

Customs Duties

Those liable are consignees who import goods permitted by China and consignors who export goods permitted by China—the former pay import duties and the latter pay export duties.

Tariffs include import duty rates and export duty rates. Import duty rates fall into two categories—general tariff rates and preferential tariff rates. The general tariff rates apply to the imports originating in the countries with which China has not concluded “most favoured nation” trade agreements, while the preferential tariff rates apply to imports originating in the countries with which China has concluded such agreements.

Customs duties are computed either on an ad valorem basis (based on value) applying an applicable rate, or on a quantity basis applying an amount of duty per unit.

The formulas are:

$$\text{Duty payable} = \text{quantity of imported/exported goods} \times \text{tax – inclusive price} \times \text{rate}$$

$$\text{Duty payable} = \text{quantity of imported/exported goods} \times \text{amount of duty per unit}$$

Major reductions and exemptions include: the duty amount to be paid for one consignment of goods if it is below RMB50, advertising materials and trade samples of no commercial value, goods gifted by international organizations or foreign governments, and fuels, stores and beverages loaded on a means of conveyance entering or leaving the country for use en route.

Raw materials, subsidiary materials parts, accessories, components and packing materials imported for overseas businesses to process, assemble or produce export-oriented products shall be exempt from duties on the portion of those actually processed and exported, or duties are collected first on the imported materials and parts and then refunded on the basis of the completed products actually processed and exported.

7 Tax Aspects of Processing and Assembly Operations

Processing and assembly operations have accounted for a significant part of China's exports and have been particularly popular amongst Hong Kong and Taiwanese investors since the early 1980s. Under this arrangement, the Chinese party (either a local Chinese company or an FIE) processes materials or assembles parts supplied from abroad by the foreign party, and then ships the completed products back to the foreign party. No local sales are allowed and the whole production must be exported.

Chinese laws provide two structures for the importation of materials and components to be processed in China for exports of final products: the *lai liao jia gong* (LLJG).

The key distinction between the two structures lies in the title of the materials and finished products. Under LLJG, the title to the raw materials is under the name of the foreign investor. The raw materials enter China on a consignment basis and the title to all the raw materials and the finished products remains with the contractor outside China. The foreign party would normally pay the Chinese party a set processing fee for each unit produced.

Under a JLJG arrangement, the wholly foreign-owned enterprise in China purchases the raw materials from its overseas suppliers for its own account and the title of the goods is passed on to the WFOE. The WFOE would then sell to the previous supplier the finished products at a margin.

Tax Issues for LLJGs

The tax situation for an LLJG is significantly simpler than with a WFOE and may suit some operations. Neither import duty nor VAT is applicable as final products are 100% exported. The CIT for the LLJG factory is based on the processing fee.

This processing fee is paid by the foreign party to the Chinese LLJG factory. This processing fee will be used towards fixed costs such as rent, wages, equipment depreciation and management fees, and variable costs such as overtime, raw material purchases and so on.

For a more detailed tax comparison between an LLJG and a WFOE, please see the table below.

Anti-avoidance Provisions and Practice

The Chinese CIT provisions contain a general anti-avoidance rule (GAAR) provision (Article 47) that states that the SAT is able to adjust a taxpayer's tax liability where a transaction

WFOEs vs LLJGs—comparison list for establishment and tax

Issue	Item	WFOE	LLJG
Establishment	Minimum registered capital	RMB30,000 for a multiple shareholder company and RMB100,000 for a single shareholder company with regional variations	N/A
	Type of company	Foreign-invested enterprise	Chinese domestic company
	Legal representative	Foreign investor	Chinese partner
	Timescale for set up	60 days	About 15 days
	Operational term	10–50 years	Less than 10 years
	Customs duties	Imported raw materials should pay the customs duty if the final products are sold domestically. Customs duty does not apply if all the final products are exported	Customs duty does not apply on imported materials
		1. Encouraged WFOE—No customs duty on imported equipment	No customs duty on non-priced equipment provided by foreign investor
		2. Export WFOE—Pay customs duty on imported equipment firstly, and then be refunded within 5 years	
		3. Other type WFOE—Pay customs duty on imported equipment	
	VAT	Normal rate is 17% based on increased value	N/A
Tax		Tax system of “exemption, set-off and refund” is practiced for the exports sales	No refund for the export sales
		VAT-In can be deducted and can apply for VAT refund	N/A
	Tax deposit	Normally need tax deposit for free duty imported materials	Normally need tax deposit for free duty imported materials
	CIT	25% based on net profit nationally	25% based on net profit nationally
	Management fee	N/A	18–25% as processing fees paid to the local government/local factory

- results in a reduction of taxable income; and
- has no reasonable business purpose.

This latter term, “no reasonable business purpose,” is defined as an action in which “the main purpose is to reduce, exempt or defer the payment of taxes.” The CIT implementation measures specifically mention the following areas for anti-avoidance investigation:

- Abusing tax preferences
- DTA or treaty “shopping”
- Avoiding tax through tax havens
- Abusing the corporate organizational form
- Any other arrangement without a reasonable business purpose

These areas of investigation are very broad, however, it is clear that the principle of “substance over form” will be increasingly applied, and the SAT will generally disregard the form of any tax arrangements and re-characterize a transaction according to its economic substance.

In fact, a number of recent cases indicate that the SAT may well intend to take a very aggressive approach to the application of the GAAR provision, particularly towards foreign companies. There have recently been a number of high profile indirect equity transfers wherein offshore transfers of indirect interests in Chinese entities with no direct connection to China have been deemed to be direct transfers of Chinese entities. Consequently, a capital gains tax is payable to the Chinese tax authorities. These decisions have put into doubt the efficacy of many holding company arrangements used by foreign investors in China. We suggest that foreign investors review their current arrangements, and new investors take specific professional advice on the structuring of investments into China.

We expect that the GAAR provision will be increasingly used by the SAT in the future.

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