

Chapter 1

LEGAL AND ADMINISTRATIVE FRAMEWORK OF CHINA TAX

Tax reform background	¶1-010
Sources of law	¶1-020
Types of laws and regulations	¶1-030
Language and interpretation of laws	¶1-040
Tax policy and administration	¶1-050
Tax laws	¶1-060
Useful contacts	¶1-070

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¶1-010 Tax reform background

China's current tax system is relatively new, having been developed only since the 1980s. Prior to that, China's tax system was concerned primarily with the taxation of domestic enterprises. With the introduction of "open door" economic policies, the tax system was reformed and developed in order to levy tax on foreigners, foreign enterprises and foreign investment enterprises.

To attract foreigners and foreign enterprises to make investment in China, China issued a separate income tax law in 1991 to tax on foreigners, foreign enterprises and foreign investment enterprises, which provided tax incentives and various favourable tax treatments, whereas domestic enterprises were governed under another tax code with less beneficial treatments, thus resulting in unbalanced taxation and unfair competition over the years. In addition, due to the existence of the two different tax regimes, there were ambiguity and inefficiency reported in tax levy and administration.

As China's economy continues to grow, efforts had been made to unify the income tax system such that foreign enterprises, foreign investment enterprises and domestic enterprises can be taxed under the same tax system. The new *Enterprise Income Tax Law* (EITL) was finally enacted in the Tenth National People's Congress on 16 March 2007. The new EITL, which unifies the income tax treatment of domestic enterprises and foreign enterprises, came into effect on 1 January 2008.

In addition to Enterprise Income Tax (EIT), China has witnessed reforms or amendments of other non-EIT taxes a few times in the past three decades, including Value-added Tax (VAT), Business Tax (BT), Individual Income Tax (IIT), Consumption Tax (CT), Urban Township Land Use Tax (UTLUT), Real Estate Tax (RET), etc. The IIT law was last amended on 30 June 2011; the UTLUT regulation was last amended on 30 December 2006; the regulations for VAT, BT and CT were last amended in November 2008. Starting from 1 January 2012, China has launched a pilot VAT programme where the taxation of specified sectors will transition to being subject to VAT rather than BT. The pilot programme initially applies to transportation and modern service industries in Shanghai and was rolled out to eight other cities/provinces during 2012, and the nationwide rollout was on 1 August 2013. The Urban Real Estate Tax (URET) regulation previously applicable to foreign investment enterprises, foreign enterprises and foreigners was abolished on 31 December 2008; instead, RET regulation has been applied to foreign investment enterprises, foreign enterprises and foreigners from 1 January 2009.

Undoubtedly, China's tax reforms conducted in the past three decades are a result of the economic development. As the economy continues to grow, additional amendments to the existing tax rules and regulations would be expected.

¶1-020 Sources of law

China's legal system is a legislative (as opposed to common law) system. The regulation-making system is not strictly centralised in practice. Regulations are codified in statutory instruments which are derived from various sources at different levels of government (from national to local) and with a hierarchical basis of authority.

According to *The Constitution of the People's Republic of China* (Constitution), supreme legislative authority is vested in the National People's Congress (NPC) and its Standing Committee, which also have the final authority to make and interpret legislation. In practice, much of this power has been delegated to the State Council.

The State Council, headed by the Premier, is the chief executive organ of government at the central level. Administrative regulations made by the State Council rank immediately below those laws enacted by the NPC. These regulations are in turn supplemented by instructions, orders and rules issued by the appropriate subordinate ministries under the State Council. The major ministry responsible for tax matters is the State Administration of Taxation (SAT).

At a provincial level, People's Congresses are empowered to make local rules and regulations, provided they do not contravene the *Constitution* or the laws made by the NPC or the administrative regulations made by State Council. People's Congresses and their Standing Committees in provinces, autonomous regions, centrally administered municipalities and large cities are authorised to make local regulations. The large cities include cities where the People's Governments of provinces or autonomous regions are located, or where Special Economic Zones (SEZs) are located, and other cities approved by the State Council. People's Governments in these jurisdictions are also authorised to make provisions or measures.

¶1-030 Types of laws and regulations

Laws promulgated by National People's Congress

Enactments promulgated by the NPC and its Standing Committee are broadly categorised as either:

- basic laws; or
- laws and amendments.

Before a new basic law is promulgated by the NPC, a bill must be introduced. New legislation proposed is usually vetted by the Legal Work Committee of NPC, which will examine and research the proposed bill, and recommend any changes that may be necessary.

The NPC commonly uses resolutions to make amendments to laws, or to enact supplementary provisions to laws and/or orders promulgating basic laws.

Administrative regulations issued by the State Council

With effect from 1 January 2002 administrative regulations issued by the State Council are normally designated as "regulations", "provisions" or "measures". (Previously the State Council also issued administrative regulations designated as "articles", "rules for observation", "guiding principles", "principles", "rules" or "detailed rules for implementation".)

Similar to enactments promulgated by the NPC, bills must be drafted and submitted to the legislative body of the State Council. Normally, draft versions are first prepared by the appropriate subordinate ministries or commissions and then submitted to the State Council for examination and approval.

All administrative regulations are published in the *Gazette* of the State Council and national newspapers. This is a requirement of the *Regulations on the Enactment of Administrative Regulations* (Art 31). Administrative regulations usually take effect 30 days after promulgation unless otherwise specified.

Other administrative documents

In addition to NPC basic laws and resolutions, and State Council administrative regulations, various other administrative documents are issued to State agencies including decrees, directives, notices and circulars which give instructions or provide clarification regarding specific laws or legal provisions.

Many of these documents have been classified as "internal" and for these, foreigners must rely on the opinion of professional advisors, or on unofficial summaries of the documents provided by Chinese business partners, in order to understand how the documents affect and alter the published laws and regulations. Chinese legal officials have recognised that practices regarding "internal" law are unsatisfactory and have pledged to reduce the number of such documents.

Local regulations and rules

There are three types of local regulations:

- regulations required to implement the laws of the central government in accordance with special local conditions;
- supplementary regulations; and
- regulations dealing with strictly local issues.

Made at a provincial level, these regulations must first be reviewed by the Legal Work Committee of NPC to ensure that they do not conflict with the

Constitution. The State Council also examines the legislation to ensure that it does not conflict with other administrative laws or superior regulations. Local regulations made below provincial level must be approved by the legislative authorities at the provincial level.

The number of local regulations is significant. Accordingly, local regulations can have a significant impact on China's legal system. Being local in nature they can lead to different consequences arising in similar matters depending on the jurisdiction. Some local regulations also may deal with topics which have not yet been regulated by national legislation.

All local government rules are published in the *Gazette* of the relevant government and local newspapers as required under the *Regulations on the Enactment of Administrative Regulations* (Art 31). They usually take effect 30 days after issue unless otherwise specified.

¶1-040 Language and interpretation of laws

The language of the law is Chinese. Where laws have been translated, the original Chinese version is the most authoritative version and should prevail in case of any conflict. The Chinese Government has produced books of Chinese laws translated into English on an ad hoc basis. CCH produces a loose-leaf library, *China Laws for Foreign Business* that contains English translations of legislation in the areas of Taxation and Customs, Business Regulation and Special Zones and Cities.

Formal interpretation of laws and regulations is conducted by government agencies and the judiciary:

- *Legislative interpretation* – the Standing Committee of the NPC interprets the Constitution, laws enacted by the NPC and laws enacted by itself which need to be further clarified or supplemented.
- *Administrative or executive interpretation* – the State Council interprets administrative regulations where questions arise relating to their application. The interpretation has the same effect as the administrative regulation in question. Ministries under the State Council interpret the rules they have made and the interpretation has the same effect as the rules in question.
- *Local interpretation* – the standing committees of provincial People's Congresses supplement or clarify the scope of local regulations and rules that they have issued. Provincial governments and their departments interpret questions of regulations arising out of their respective local rules and regulations. The interpretation has the same effect as the rules or regulations in question and is only binding in the jurisdiction concerned.

- *Judicial interpretation* — technically, the Supreme People's Court and the Supreme People's Procuratorate are limited to making binding interpretations of laws only within the context of trial and procuratorial work. However, the power of the Supreme People's Court to interpret national legislation has been expanding in practice. The Court has given detailed "explanations" of major laws (eg *Civil Law*, *Security Law*) without which it would be impossible to enforce national laws which have been framed in general principles and vague terms. The power of the Supreme People's Court is, however, restricted to interpreting laws promulgated by the NPC and its Standing Committee (except the Constitution). Generally, it will not interpret administrative regulations, government rules or local rules and regulations.

¶1-050 Tax policy and administration

The SAT and Ministry of Finance (MOF) are empowered to interpret the country's tax laws and regulations by the issuance of circulars to its branches, rulings, notices and replies.

Responsibility for tax policy and administration lies with the SAT. The SAT is responsible for formulating and coordinating tax policies and for supervising the work of local tax bureaus which are established as provincial and municipal levels. The MOF also continues to play a key role in developing tax legislation and policy.

The State Council has stipulated that the SAT is responsible for the collection and administration of taxes that generate revenue for the central government or revenue which is shared between the central and local governments. Local tax bureaus of State tax are in charge of the day-to-day administration of State tax matters.

Local taxes are handled by bureaus of local tax in the relevant locations. Local tax bureaus are responsible for collecting taxes that only generate revenue for the respective local governments. Although the authority for tax collection is divided, the local tax bureaus must follow the direction of the SAT with respect to tax policy and the interpretation of tax laws and regulations.

In most locations, specialised departments under the State tax bureaus and local tax bureaus respectively handle matters relating to tax collection and enforcement of foreign individuals, foreign enterprises and foreign investment enterprises.

The Offshore Oil Taxation Bureau manages tax enforcement and collection for businesses involved in offshore oil exploitation.

¶1-060 Tax laws

China's tax system has evolved in a piecemeal fashion and reflects the complexity of China's legal system. There is no single tax law or code governing the taxation of individuals and enterprises. Rather, separate laws and regulations impose different taxes on different taxpayers and on different types of activities; and different reporting structures and payment procedures apply to different taxes.

This publication covers 16 taxes imposed in China:

- individual income tax;
- enterprise income tax;
- turnover and consumption taxes, surtaxes — value-added tax, business tax, consumption tax, city maintenance and construction tax, and national/local education surcharges;
- transaction and property taxes — stamp duty, deed tax, land value-added tax, urban and township land use tax, real estate tax, farmland occupation tax and resource tax; and
- customs duty.

Note: Strictly speaking, national/local education surcharges are not "taxes". Nevertheless, it will be covered in this publication as they are generally levied and collected with city maintenance and construction tax.

Each tax is typically implemented by a basic law or regulation and may be supplemented by implementing regulations and tax-specific rulings and interpretations in the form of circulars issued by the MOF or the SAT.

The basic tax laws set out the broad principles of the respective taxes while the implementing regulations contain detailed provisions concerning the scope of the tax, applicable persons, calculation of tax charge, timing of payment, etc. The implementation rules for the EITL were officially issued on 6 December 2007. Following the EITL and the implementation rules, a number of circulars were issued to have clarified certain tax treatments during the grandfathering period, from 1 January 2008 to 31 December 2012, and have cleared up certain tax circulars and notices that were issued under the old tax regime and are no longer applicable under the new law. In addition, a flurry of tax circulars were issued to have addressed various uncertain issues that are not explicitly clear under the new EITL and its implementation rules. Notwithstanding the above, there are still uncertain issues subject to further clarification and more circulars are expected to come to provide guidance for taxpayers.

The rulings issued by the MOF or the SAT are issued to clarify specific issues which may be raised by local tax authorities, taxpayers or the courts.

- For the land acquired as substitution of any expropriated land in the process of relocation, the tax basis of the newly acquired land shall be the net value of the expropriated land adding up various expenditures incurred on the newly acquired land for use. After the newly acquired land is put into use, amortisation shall be provided over the period in accordance with the provisions of the EITL and EITIR.
- For the assets newly purchased in the process of the relocation, the tax basis and the depreciation or amortisation life of such assets shall be calculated or determined pursuant to the relevant provisions of the EITL and EITIR. The expenditures incurred for purchasing the assets shall not be deducted from the relocation income.

Chapter 7

WITHHOLDING TAX UNDER DOMESTIC LAW

Application of withholding tax.....	¶7-010
Withholding tax rate	¶7-020
Withholding tax rates under tax treaties.....	¶7-030
Dividends	¶7-100
Royalties	¶7-110
Interest	¶7-120
Rental income	¶7-130
Guarantee fees	¶7-140
Income from transfer of properties.....	¶7-150
Other China-sourced income	¶7-160
Procedures for withholding tax payment.....	¶7-200

¶7-010 Application of withholding tax

Non-resident enterprises without establishments in China are subject to enterprise income tax on a withholding basis on the following categories of China-sourced income (with very limited exemptions):

- Dividend income and profit distributions, which refer to income derived by an enterprise from its invested entities as a result of the equity investment made therein;
- Royalty income, which refers to income derived by an enterprise from providing use rights for patent, non-patent technology, trademark, copyright and other licence rights;
- Interest income, which refers to the income derived by an enterprise from provision of funds to other parties that does not constitute equity interests or from the possession of the enterprise's funds by other parties, including the saving interest, loan interest, bond interest, debt interest, etc;
- Rental income, which refers to income derived by an enterprise from providing use rights for fixed assets, packaging materials and other tangible assets;
- Gains from transfer of assets, which refer to income derived by an enterprise from transferring fixed assets, biological assets, intangible assets, capital investments, creditor's rights, etc; and
- Other income derived from inside China which may be deemed taxable by the government authorities of the State Council in charge of finance and taxation.

(EITL, Art 3, 6, 19; EITIR, Art 6, 16, 17, 18, 19, 20)

The EITIR further sets the principles below for determining the source of the abovementioned items of income (EITIR, Art 7):

- For dividend and profit distributions, source is determined in accordance with the place of the enterprise which makes the distribution;
- For income from royalties, interest and rental, source is determined in accordance with the place of the enterprise or establishment in China which bears or pays the income, or with the place of domicile of the individual who bears or pays the income;
- For income from transfers of immovable properties, source is determined in accordance with the place where the immovable properties are located; for income from transfers of movable properties, source is determined in accordance with the place of the transferor enterprise or establishment which transfers the movable properties;

- For income from transfers of equity interests, source is determined in accordance with the place where the invested enterprise is located; and
- For other income, source will be determined by the government authorities of the State Council in charge of finance and taxation.

Non-resident enterprises with establishments in China deriving the above-listed income which is not effectively connected with that establishment are also subject to EIT on a withholding basis.

Withholding tax is imposed on the total income (including all payments and additional surcharges) derived by a non-resident enterprise from a payer (EITIR, Art 103).

¶7-020 Withholding tax rate

According to Art 4 of EITL, withholding tax rate is 20%. The EITIR (Art 91) reduces withholding tax rate to 10% for all the income items specified in ¶7-010.

¶7-030 Withholding tax rates under tax treaties

The withholding tax rates specified in the domestic tax law and regulations may be reduced by the applicable tax treaties. However, the vast majority of China's tax treaties generally do not provide relief for the withholding tax treatment that is already available under the domestic law.

A table of withholding tax rates under tax treaties is provided in Chapter 11 *Double Tax Relief* (¶11-070).

¶7-100 Dividends

Dividend income and other distributions with respect to the equity interest refer to income derived by an enterprise from its investee as a result of the equity investment made therein.

Unless otherwise stipulated by the government authorities of the State Council in charge of finance and taxation, dividend income is recognised on the date when the profit distribution is legally declared by the invested entity (EITIR, Art 17). Withholding tax on dividend distribution to a non-resident enterprise shall be made on the same declaration date. If the actual payment date precedes the said declaration date, tax shall be withheld by the Chinese resident enterprise at actual payment date (*Announcement of SAT (2011) 24 (Announcement 24)*).

Under the EITL, dividend distributions are subject to a 10% withholding tax rate. The EITL repealed the withholding tax exemption for dividend distribution under the old tax law. The dividend derived from the profits generated after 1 January 2008 would be subject to 10% withholding tax (*Caishui*

(2008) 1, Art 4), while distributions from pre-2008 profits may still enjoy withholding tax exemption even if the dividend is declared and distributed after 1 January 2008.

Under the old law, dividends paid to foreign investors in respect of A Shares, B Shares, H Shares and other overseas listed shares were exempt from withholding tax.

However, under the current EIT regime, the Chinese resident enterprise is required to withhold withholding tax on dividend distributed to non-resident share shareholders with respect to A Shares, B Shares, H Shares and other overseas listed shares.

Total dividend income shall be taxable with no deduction allowed (EITL, Art 19).

¶7-110 Royalties

Royalties derived by non-resident enterprises without establishments in China, and who provide patent rights, proprietary technology, trademarks and copyrights within China, are subject to withholding tax. The royalty income shall be recognised when the royalty becomes payable by the licensee as provided in the licence agreement (EITIR, Art 20).

Circular *Guoshuihan* (2009) 507 is the prevailing rule that clarifies the application of royalties article in China's tax treaties.

For more detail of this circular, you may refer to the relevant section under Double tax relief (¶11-750).

Withholding tax exemption

Under the old income tax law, certain royalty incomes may be exempt from withholding tax. Upon the approval by the SAT, the exemption may apply to royalties received for the supply of technical know-how in scientific research, exploitation of energy resources, development of communications industries, agricultural, forestry and animal husbandry production, and the development of important technologies, provided that the know-how is technologically advanced or the terms are preferential.

The EITL and its Implementation Rules do not grant the same benefit as mentioned above. According to *Guoshuifa* (2008) 23, royalties received under a contract signed before the end of 2007 may continue to enjoy such exemption till the expiry of the contract; however, such exemption would not be applicable to the extension of the contract, supplementary contract or any expansion of the contract.

Deduction of business tax or value-added tax ("VAT")

According to the new EITL and its Implementation Rules, the total royalty payment is subject to withholding tax with no deduction (EITL Art 19; EITIR Art 103). *Caishui* (2008) 130 specifies that business tax paid on royalty income is not deductible for withholding tax purposes.

The EITL repealed the rules under the old tax law regime, which had allowed business tax paid to be deductible for withholding tax purposes (*Caishuizi* (1998) 59).

Under the VAT reform that initially launched in Shanghai on 1 January 2012 and implemented nationwide since 1 August 2013, royalty income is generally subject to VAT. Non-resident enterprises derive royalty income shall treat the full amount of income exclusive of VAT as taxable income amount for the purpose of computation and payment of withholding income tax (*Announcement of SAT* (2013) 9).

¶7-120 Interest

Interest income refers to the income derived by an enterprise from provision of funds to other parties that does not constitute equity interests or from the possession of the enterprise's funds by other parties, including the saving interest, loan interest, bond interest, debt interest, etc.

Interest income derived from China by foreign enterprises without establishments in China is subject to the relevant withholding tax at 10%, or a lower tax treaty rate, unless specifically exempted as stated below.

Interest income shall be recognised when the interest becomes payable as provided in the agreement (EITIR, Art 18).

Total interest income shall be taxable income (EITL, Art 19). Similar to royalties, business tax paid on the interest is not deductible for withholding tax purpose.

Interest income derived from a finance lease

A cross-border finance lease is a lease arrangement under which a foreign enterprise (the lessor) leases facilities or equipment to a Chinese enterprise (the lessee) for a certain period, where ownership ultimately passes to the Chinese enterprise at the end of the lease period. The lessor has the entire economic value of the assets over the expected life of the lease (*Announcement 24*).

Where a non-resident lessor (without any establishment in China) derives income from aforementioned cross-border finance lease, *Announcement 24* clarifies that the lessor's income shall be treated as interest and subject to 10% EIT (unless a lower treaty rate applies). The income shall be calculated as total leasing payment plus any charges to the lessee when the ownership is ultimately passed, less the actual costs of the facilities or equipment. The lessee

(the Chinese enterprise) is the withholding agent for this enterprise income tax at each payment date.

Exemptions

Under Art 91 of the EITIR, the following items would be exempted from withholding tax:

- interest income attribute to loans from foreign governments to the Chinese Government;
- interest income attributable to preferential loans from international financial organisations to Chinese Government and resident enterprises; and
- other income approved by the State Council.

In addition, interest income derived by foreign enterprises without establishments in China may also be subject to business tax at the rate of 5%. Previously, in a tax circular *Guoshuifa (1997) 35 (Circular 35)*, the tax authorities have clarified that the said 5% business tax is not imposed on interest income derived by foreign enterprises without establishments in China. However, *Circular 35* was withdrawn in April 2006. Furthermore, under the amended PRBTIR effective from 1 January 2009, business tax is imposed on service income where either the service provider or the service recipient is located in China. It appears that 5% business tax should be withheld from the interest income derived by foreign entities providing loans to Chinese enterprises (including foreign-invested banks incorporated in China and foreign banks' branches in China) or individuals.

¶7-130 Rental income

Rental income refers to income derived by an enterprise from providing use rights for fixed assets, packaging materials and other tangible assets.

Rental income shall be recognised when the rental becomes payable as provided in the lease agreement (EITIR, Art 19).

Total rental income shall be taxable income, and no deduction may be allowed (EITL, Art 19).

Rental income received from leasing property in China is subject to withholding tax at the rate of 10%, or a lower tax treaty rate where applicable.

Under the old tax law regime, transportation fees, packaging fees, insurance fees, etc, paid by the lessee shall be added to the rental income received by the foreign enterprise providing the leasing facilities, and the total amount will be taxed at an applicable rate on a withholding basis. (*Caishuiwaizi (1985) 210*).

It is our understanding that, in general, unless otherwise provided by the new rules in the future, the general principle under this rule (that was issued before the new EITL took effect) may continue to apply under the new EITL.

Announcement 24 states that the whole amount of rental income derived from the leasing of real estate should be subject to EIT if the non-resident enterprise owning the property does not have an establishment in China for managing the property. The lessee within the territory of China is the withholding agent for the tax imposed.

The non-resident enterprise property owner will be considered as having an establishment in China under each of the following cases, where it shall file tax returns and pay EIT accordingly:

- the owner assigns persons to conduct routine management of the property; or
- the owner conducts the management through an agent located in China.

In addition, rental income derived by non-resident enterprises without establishments in China from leasing of immovable property in China is also subject to 5% business tax pursuant to the new PRBTIR.

Similar to royalties, according to *Caishui (2008) 130*, business tax on rental income is not deductible for withholding tax purpose.

¶7-140 Guarantee fees

The withholding tax provisions of the EITL and the EITIR do not specifically provide for the withholding tax treatment of guarantee fees.

Under *Announcement 24*, which is consistent with *Caishuizi (1998) 1* which had been abolished, withholding tax is imposed on China-sourced guarantee fees received by non-resident, at the tax rate applicable to interest income as prescribed in EITL and EITIR, which is presently at a rate of 10%.

Scope of guarantee fees

According to *Announcement 24*, "China-sourced guarantee fees" refers to guarantee fees or fees of similar nature paid or borne by domestic enterprises, organisations or individuals for guarantees provided by non-resident enterprises in business activities, including lending, trading, goods transportation, processing, leasing, contractual projects, etc.

The PRC *Guarantee Law* defines the scope of guarantee fees to be covering all kinds of business activities, including corporate lending by foreign banks.

Chapter 13

VALUE-ADDED TAX

Introduction to value-added tax ¶13-010

LIABILITY TO TAX

Goods and services subject to VAT ¶13-110
 Taxpayers liable for VAT ¶13-120
 Small-scale taxpayers ¶13-130
 General taxpayers ¶13-140
 Exempt goods ¶13-150
 Non-taxable services ¶13-160

TAX CALCULATION

VAT rates ¶13-310
 VAT calculation formula for general taxpayers ¶13-320
 Sales value ¶13-330
 Output tax and input tax ¶13-340
 Non-creditable input tax ¶13-350
 Simplified VAT calculation for small-scale taxpayers ¶13-360
 Calculation of VAT on imports ¶13-370
 Sales of goods with different VAT rates ¶13-380
 Mixed-sales activities ¶13-390
 Concurrent non-taxable and taxable activities ¶13-400
 Software industries ¶13-410
 Exclusion of VAT from sales value ¶13-420
 VAT incentives for equipment purchased by R&D centres ¶13-430

VAT TREATMENT OF EXPORTS

Tax refund upon exportation ¶13-610
 Goods eligible for tax refund/exemption ¶13-620
 Tax refund rates ¶13-630
 Calculation of refund ¶13-640
 Tax refund administrative procedures ¶13-650
 Special procedures for certain enterprises ¶13-660
 Treatment of goods in free trade zone (FTZ) ¶13-670
 Treatment of goods in export processing zone (EPZ),
 bonded logistic park (BLP) and bonded port (BP) ¶13-680
 VAT refund (exemption) of used equipment ¶13-690
 Offences and penalties ¶13-700

PAYMENT OF VAT

Time at which VAT liability arises	¶13-810
Due date for payment	¶13-820
Location for payment	¶13-830

VAT INVOICES

Use of VAT invoices	¶13-910
Form of invoice	¶13-920
Procedure for sales returns or sales allowances	¶13-930
Improper use of invoices	¶13-940
Lost, stolen, fraudulent or unauthorised invoices	¶13-950

VAT REFORM — PILOT PROGRAMME

Summary of VAT reform pilot programme	¶13-1000
Background of VAT reform pilot programme	¶13-1010
Principles of VAT reform pilot programme	¶13-1020
Scope of services subject to VAT	¶13-1030
VAT taxpayers under VAT reform	¶13-1040
Transitional rules	¶13-1050
Tax rate	¶13-1060
Sales revenue	¶13-1070
Input VAT deduction and supporting evidence	¶13-1080
Calculation of tax refund	¶13-1090
Tax invoices	¶13-1095

¶13-010 Introduction to value-added tax

Value-added tax (VAT) is a turnover tax levied on all units and individuals engaged in:

- the sale of goods;
- the provision of processing, repair or replacement services; or
- the importation of goods.

within the territory of the People's Republic of China (PRVAT, Art 1).

Taxable "units" include enterprises, administrative units, institutions, military units, social organisations and other units (PRVATIR, Art 9). Taxable "individuals" include individual business operators and other individuals who are engaged in taxable activities.

VAT is calculated based on the sales value of goods obtained, the value of taxable services received, or the value of goods imported. The tax is named "value added tax" because it is imposed on the added value, or the increase in value, of a commodity as it goes through each stage in the process of circulation.

VAT payable by taxpayers is calculated as follows:

- (1) A taxpayer who engages in the sale of goods or the provision of taxable services will calculate the tax based on the amount received from the sale of goods or taxable services by applying a given tax rate.
- (2) The tax thus calculated, the "output tax", is reduced by the amount of "input tax" that has been paid on the purchase of goods or taxable services as indicated on the VAT invoices issued with the purchases (see ¶13-910).
- (3) The net amount is the VAT payable by the taxpayer.

Prior to 1 January 1994, VAT was levied under the *Regulations of the People's Republic of China on Value-added Tax* which were promulgated by the State Council in 1984. VAT was levied on units or individuals within the territory of China who were engaged in the production of certain industrial products or the importation of commodities. VAT was not applicable to foreign investment enterprises or foreign enterprises which, at that time, were subject to industrial and commercial consolidated tax.

At the end of 1993, the Chinese Government conducted a large-scale reform of the overall tax system, focusing mainly on the reform of VAT and other turnover taxes. The present PRVAT came into effect on 1 January 1994, annulling the *Regulations of the People's Republic of China on Value-added Tax*. PRVAT encompassed the following major changes:

- The scope of application of VAT was widened to a broader collection of tax on wholesale and retail sales of goods, imports, and the provision of processing, repair and replacement services; and all foreign investment enterprises and foreign enterprises engaging in such taxable activities are liable to tax.
- VAT is now calculated using the “off-price” method, ie using the “VAT exclusive” price (see further ¶13-420). Prices including VAT and prices excluding VAT are separately accounted for on the VAT invoice.
- The amount of input tax can be credited against or deducted from the amount of output tax based on the amount indicated on VAT invoices (see ¶13-320).

At the end of 2008, the Chinese Government amended the PRVAT and the PRVATIR. The amended PRVAT and PRVATIR are effective from 1 January 2009. The most fundamental and core change in the amendment is the recovery of VAT incurred on fixed assets, reflecting the essence of the transition from a production to consumption based VAT system.

At the end of 2011, the Chinese Government amended the PRVATIR again, and the only revision was the enhancement of the VAT tax threshold for individual taxpayers (see ¶13-120).

On 26 October 2011, the State Council announced that it would launch the pilot VAT reform programme on 1 January 2012. The pilot programme initially applied to transportation and modern service industries in Shanghai and was rolled out to other provinces and areas including Beijing, Tianjin, Jiangsu, Zhejiang, Anhui, Fujian, Hubei, and Guangdong in 2012; it was further rolled out nationwide on transportation and certain service industries on 1 August 2013. The aim of the pilot programme is to resolve the double taxation issues under the prevailing system and to foster the development of specified modern service industries by gradually transitioning these industries from liability to Business Tax to liability to VAT (see ¶13-1010 to ¶13-1095).

LIABILITY TO TAX

¶13-110 Goods and services subject to VAT

Generally, all units and individuals who are engaged in the sale of goods, the provision of processing, repair and replacement services, or the importation of goods, within the territory of the People’s Republic of China, are subject to VAT (PRVAT, Art 1).

PRVATIR (Art 2) clarifies the scope of VAT:

- “Goods” = tangible moveable property, as well as electricity, heat and gas.
- “Processing” = the business of processing goods under contract, where the contractor supplies the raw or major materials and the subcontractor manufactures the goods, according to the requirements of the contractor, and receives a processing fee.
- “Repair and replacement” = the business of carrying out repairs of damaged or malfunctioning goods under contract in order to restore the goods to their original condition and function.

Additional activities within scope of VAT

VAT is also currently levied on:

- the sale of commodity futures and precious metal futures – VAT is levied when the futures are recognised and realised (*Guoshuifa* (1993) 154);
- the sale of gold and silver by banks (*Guoshuifa* (1993) 154);
- the production and issue of stamp products for stamp collections and for sale by units and individuals other than the Ministry of Post and Telecommunication (*Caishuizi* (1994) 26);
- the sale of articles for pawn and the sale of consignment goods on behalf of a consignor (*Guoshuifa* (1993) 154);
- finance lease operations without prior approval from the People’s Bank of China and Ministry of Foreign Trade and Economic Cooperation (MOFTEC) (now known as the Ministry of Commerce (MOFCOM)) – VAT is applicable if ownership of the leased product has been transferred to the lessee (*Guoshuifan* (2000) 514; *Guoshuifan* (2000) 909);
- the issuance of newspapers and journals by units and individuals other than Post Units (*Caishuizi* (1994) 26);
- the production and distribution of silver contained in concentrated silver mines or other concentrated non-ferrous metal mines, medium refinery products and finished silver products (*Guoshuifa* (2000) 51);

- the fees charged by electric power enterprises on electricity generation enterprises to enter the power grid (*Guoshuihan* (2004) 607); and
- transportation and certain modern services which are included in the VAT pilot programme within the pilot area (*Caishui* (2013) 37), see ¶13-1030 for more details.

Deemed "sales of goods"

A "sale of goods" is the assignment of ownership of goods for compensation in the form of currency, goods or other economic benefits (PRVATIR, Art 3). To prevent VAT being avoided or evaded, the following activities are also deemed to be "sales of goods", which are subject to VAT (PRVATIR, Art 4):

- supplying goods to others for sale on a commission basis;
- selling commissioned goods or goods under consignment;
- transferring goods from one establishment to another for sale by a taxpayer who maintains more than one establishment and adopts consolidated accounting system (except where the establishments are located in the same county or city);
- applying self-manufactured goods, or goods processed on a commission basis, to non-taxable projects;
- providing self-manufactured goods, goods processed on a commission basis or purchased goods to other units or individual business operators as investments;
- distributing self-manufactured goods, goods processed on a commission basis or purchased goods to shareholders or investors;
- using self-manufactured goods, or goods processed on a commission basis for collective welfare or personal consumption; and
- handing out self-manufactured goods, goods processed on a commission basis or purchased goods as free gifts.

Mixed sales activities

A sales activity that involves sales of goods as well as the provision of non-taxable services (see ¶13-160) is referred to as a "mixed sales activity". Mixed sales activities of enterprises, units or individual business operators engaged in production or the wholesale or retail sale of goods are regarded as "sales of goods" and are subject to VAT (PRVATIR, Art 5). Mixed sales activities conducted by other units and individuals are regarded as non-taxable services and are not liable for VAT.

See ¶13-390 for more on the treatment of mixed sales activities.

¶13-120 Taxpayers liable for VAT

Units

All units engaged in the sale of goods, importation and provision of taxable services are VAT taxpayers, including:

- enterprises;
- administrative units;
- institutions;
- military units;
- social organisations; and
- other units (PRVATIR, Art 9).

For enterprises which lease or contract out management functions to others, the lessees or the subcontractors are the VAT taxpayers (PRVATIR, Art 10).

Individuals

Individuals engaged in the sale or importation of goods, or the provision of taxable services, including individual business operators and other individuals, are VAT taxpayers if their sales value exceeds the VAT tax threshold determined by the tax authorities (PRVATIR, Art 37; PRVAT, Art 17).

The range of the VAT tax threshold is prescribed in PRVATIR (Art 37).

- VAT threshold on the sales of goods = sales value of RMB5,000 to RMB20,000 per month (previously RMB2,000 to RMB5,000 per month);
- VAT threshold on the provision of taxable services = sales value of RMB5,000 to RMB20,000 per month (previously RMB1,500 to RMB3,000 per month); and
- VAT threshold on tax paid on a per transaction basis = sales value of RMB300 to RMB500 per transaction per day (previously RMB150 to RMB200).

Regional and provincial finance and tax authorities determine the applicable taxable thresholds for individual taxpayers in their regions and provinces within the above-prescribed ranges.

Withholding agents

For overseas units or individuals which do not have any business establishment in China, but sell goods and provide taxable services within the territory, their agents are required to act as withholding agents in respect of the VAT payable. If there are no such agents, the purchasers will be the withholding agents.

Chapter 19

TRANSFER PRICING — RULES, CONCEPTS AND METHODS

TRANSFER PRICING — RULES, CONCEPTS AND METHODS

General overview	¶19-100
Laws and regulations	¶19-200

BASIC CONCEPT

Associated enterprises	¶19-310
The arm's length principle	¶19-320
Comparability of data	¶19-325
Inter-quartile range	¶19-330
Capital adjustments	¶19-340
Location specific advantages	¶19-345
Types of related party transactions	¶19-400
Focus on intangible transactions	¶19-405

FUNCTION AND RISK — CHARACTERISATION OF ENTERPRISES

Function and risk — characterisation of enterprises	¶19-500
Manufacturing enterprises	¶19-510
Distribution enterprises	¶19-520
Tax authority approach to functional analysis	¶19-530

METHODOLOGIES OF TRANSFER PRICING

Methodologies of transfer pricing	¶19-600
Comparable uncontrolled price method	¶19-610
Resale price method	¶19-620
Cost plus method	¶19-630
Transactional net margin method	¶19-640
Profit split method	¶19-650

TRANSFER PRICING CONTEMPORANEOUS DOCUMENTATION

General introduction	¶19-700
Contents of contemporaneous TP documentation	¶19-710
Consequence of non-compliance	¶19-720

TRANSFER PRICING INVESTIGATION AND AUDIT

Transfer pricing administration and audit targets.....	¶19-740
Adjustment and remedies	¶19-745

ADVANCE PRICING AGREEMENTS (APAs)

General introduction.....	¶19-750
APA procedures	¶19-755
APA statistics	¶19-760
Trends for transfer pricing in China.....	¶19-765

TRANSFER PRICING — RULES, CONCEPTS AND METHODS**¶19-100 General overview**

When two associated enterprises conduct business with one another, the price negotiated between the two is typically referred to as a transfer price. As a special relationship exists between associated enterprises, tax authorities are concerned that transfer prices may be different from the prices that would be agreed between two independent enterprises.

The lack of global tax systems and different tax rates around the world provide a perceived incentive for multinational companies (MNCs) to formulate their transfer prices to recognise low profits in jurisdictions with higher tax rates, and high profits in jurisdictions with lower tax rates. By doing this, MNCs could reduce their aggregate tax payable.

To prevent this, tax authorities around the world have enacted tax rules and regulations to govern transactions between associated enterprises (controlled transactions) and to prevent the inappropriate transfer of profit. This ensures that transactions between associated enterprises in their jurisdictions are appropriately taxed.

¶19-200 Laws and regulations

There have been many regulatory changes to China's transfer pricing rules in recent years. The new *Enterprise Income Tax Law* (EITL) was released in March 2007, and the *Enterprise Income Tax Implementation Rules* (EITIR) was released in December 2007. Both of these came into effect on 1 January 2008. These rules unified income tax rates for foreign and domestic invested companies, and also introduced a platform for other changes made to transfer pricing rules.

In addition to the EITL and EITIR, the *Administrative Law of the People's Republic of China on the Levying and Collection of Taxes* and its implementation rules also provide some administrative rules on transfer pricing.

The *Implementation Regulations for Special Tax Adjustments* (Trial) (*Guoshuifa* (2009) 2, commonly referred to as "Circular 2"), released in January 2009, provides the much needed detailed guidance on a number of transfer pricing and other issues and is retrospective to transactions from 1 January 2008. Following the promulgation of *Circular 2*, other important circulars which impact China's transfer pricing regime have been introduced. These often have retrospective effect to cover transactions from 1 January 2008.

The effects of the regulatory changes on taxpayers and their continued implications are substantial. Among other things, *Circular 2*:

- established contemporaneous documentation requirements for related-party transactions, to be prepared and maintained in Chinese;

- included the first guidance in China's transfer pricing regulations for the use of the inter-quartile range; however, tax bureaus are still explicitly entitled to make adjustments up to the median in any year an enterprise's results are below the median;
- for the first time formally permitted Cost Sharing Agreements (CSAs) for qualified intangible development activities and certain types of shared services;
- provided guidance on applying for Advance Pricing Agreements (APAs), including unilateral, bilateral and multilateral APAs, as well as APAs involving multiple entities in China;
- established thin capitalisation rules;
- introduced general anti-avoidance rules; and
- otherwise changed the compliance landscape, including requiring enterprises to fill out nine very detailed related-party transactions disclosure forms when filing their annual tax returns, in which taxpayers have to indicate whether or not they have prepared transfer pricing documentation as required by law, especially as required by *Circular 2*.

Beyond *Circular 2*, national (as well as local) level circulars and notices have continued to be issued on a regular basis that clarify and/or expand the requirements of *Circular 2*. A particularly important one is the *Circular of the State Administration of Taxation on Strengthening the Supervision over and Investigation of Cross-border Connected Transactions* (*Guoshuihan* (2009) 363, referred to as "*Circular 363*"). It states:

"Enterprises established by a multinational enterprise within the territory of China to bear limited functions and risks such as mono-production (processing with supplied materials or processing with imported materials), distributions or contractual research and development, are not to bear risks such as market risk, decision-making risk, etc, in the financial crisis, and shall maintain reasonable profits pursuant to the transfer pricing principle that functions and risks match profits."

In addition to domestic Chinese regulations, in October 2012 China's summary of country practices were published as part of the United Nations Transfer Pricing: Practical Manual for Developing Countries. The Chinese submission was intended to highlight a number of the issues faced by developing countries and to share China's practical experience when dealing with these issues. These past practices may indicate the approach the Chinese tax authorities will take in the future.

BASIC CONCEPT

¶19-310 Associated enterprises

If a country's tax authority determines that a direct or indirect relationship of ownership or control exists between two or more enterprises in their operational, commercial, and financial relations, these enterprises may be considered as "associated enterprises". *Circular 2* sets out the relationships that will cause an enterprise and another enterprise, business organization or individual to be associated enterprises in Art 9.

China, like many other countries, utilises two types of tests to determine whether enterprises are related: the first is based on equity ownership, and the second on effective control (for which several types of test are included in the regulations).

The first of the two types of tests for associated enterprises is based on equity ownership. The equity ownership tests are set out in Clause 1, and deem that one party is associated with another where:

- One party directly or indirectly holds a total of 25% or more of another party's shares.
- A third party directly or indirectly holds a total of 25% or more of the shares of both companies.

When following these tests, if one party A owns shares of the other party B through an intermediary C, if A owns 25% or more of the shares of C, then A's shareholding percentage of B will be considered the same as the intermediary's.

There are seven different tests for associated party relationships through effective control which are set out in Clauses 2 to 8. In each test, the effective control is linked to control through non-shareholding relationships, or economic relationships. In brief, the tests deem two parties to be associated where:

- Debts of one party to another exceed 50% of the others registered capital, or if one party is guaranteeing 10% of the others total debt. (Clause 2)
- One party has appointed half of the senior management personnel, or one senior director with influence, of the other party; or a third party has done the same for the two other parties. (Clause 3)
- Half of one party's senior management/a senior director with influence concurrently hold senior management positions/a senior director role with influence in another party. (Clause 4)
- One party's normal production and operation is dependent on intangibles licensed by the other. (Clause 5)

- One party's purchase or sales activities are primarily controlled by another party. (Clause 6)
- One party's provision or receipt of services is primarily controlled by another party. (Clause 7)
- One party has substantial control over another party's production, operation and transactions, or they have other major relationships involving interests. (Clause 8)

To date, the tests for effective control have not been subject to significant enquiries by in-charge authorities. The wide scope of the tests may also mean that some entirely third party arrangements are also subject to the Chinese transfer pricing regulations.

¶19-320 The arm's length principle

The arm's length principle is the fundamental principle on which transfer pricing is based. The key factor for tax authorities when determining whether the transfer price used in a controlled transaction is reasonable is whether the transaction has been priced according to the arm's length principle.

The main economic concept behind the arm's length principle is that all parties to a business transaction seek to maximise their profit — this is logical when the parties are unrelated and that is why it has been the basic principle for determining the profits that associated enterprises should earn. Their relative profits will depend on their bargaining power, and the functions, assets and risks that they bring to a transaction.

Therefore, the principle hypothesises is that the individual members of an MNC are a collection of independently operating entities, maximising their profits in the same way as independent enterprises.

The arm's length principle requires that the transfer price charged in transactions between associated enterprises be equivalent to that charged between independent enterprises under identical or similar market conditions.

When applying the arm's length principle, it is necessary to compare the terms and conditions used in the controlled transaction with those used in transactions between independent enterprises ("uncontrolled transactions"). For such comparisons to be effective, the relevant economic characteristics of the two types of transactions must be comparable. This means that the differences (if any) between the transactions being compared should not materially affect the condition being examined in the methodology (that is, either price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences.

If an MNC follows the arm's length principle and incurs a loss due to an industry recession, global economic crisis or micro-economic pressures, the

MNC needs to demonstrate to the tax authority that the unfavourable economic conditions caused the loss, rather than non-arm's length transfer pricing. If the explanations and reasons are accepted by the tax authority, evidence of an expected recovery may be required. Most tax authorities around the world will not accept the transfer prices of companies that persistently break even or incur losses without justification.

¶19-325 Comparability of data

In order to demonstrate that controlled transactions follow the arm's length principle, taxpayers are required to show that the transfer price adopted is equivalent to the price of an uncontrolled transaction. This is best done using comparable transactions, ie an uncontrolled transaction that has the same terms and conditions as the controlled transaction.

Where no comparable transactions exist, an alternative comparison can be made by identifying unrelated companies that perform similar functions, possess similar assets and take similar risks as the taxpayer. These comparable companies should have similar transactions and operate under similar conditions as the taxpayer.

The lack of public and reliable information on comparable companies is a challenge for taxpayers in developing countries. Lacking publicly listed comparable companies and opaque or unreliable private company data, taxpayers generally look for comparable data from other jurisdictions. The Chinese tax authorities generally accept that taxpayers make reference to overseas comparable data for these reasons.

In the China country section of the United Nations Transfer Pricing: Practical Manual for Developing Countries, it is stated that:

"China takes the view that there may be instances where the differences in geographical markets are so material that it warrants comparability adjustments to bridge the differences."

Effectively this means that geographic adjustments may be required where there are material differences between the economies that the Chinese taxpayer and the comparable company are operating.

¶19-330 Inter-quartile range

In general, transfer pricing analyses use inter-quartile range of a benchmarked set to set the threshold for arm's length results. This is because for those data points that lie on the extremes of the range, there is a risk that these observations are anomalous and, therefore, unrepresentative of an arm's length return. As such, it is a relatively conservative position to use the "inter-quartile range" as the threshold for acceptable results.