Corporate taxation in China
Prepare for opportunity
A practical guide from the Economist Intelligence Unit

Market outlook

	2010	2011	2012	2013	2014	2015
Population (m)	1,312	1,320	1,328	1,335	1,342	1,349
GDP (US$ bn at market exchange rates)	5,878	6,821	8,090	9,569	11,196	12,973
GDP per head (US$ at market exchange rates)	4,479	5,166	6,092	7,166	8,341	9,618
GDP (US$ bn at PPP)	10,241	11,388	12,724	14,162	15,756	17,533
GDP per head (US$ at PPP)	7,803	8,625	9,582	10,606	11,738	12,999
Household consumption (US$ bn)	2,050.4	2,498.8	2,995.9	3,614.8	4,314.6	5,075.1
Household consumption per head (US$)	1,560	1,890	2,260	2,710	3,210	3,760
Exports of goods & services (% change)	15.8	8.6	9.6	9.0	8.9	9.1
Imports of goods & services (% change)	14.0	10.0	10.5	12.3	12.0	11.1

Foreign companies continue to be attracted by the opportunities offered by China's large and rapidly growing economy. China has a population of over 1.3bn, and the size of the economy is likely to grow to just under US$13trn a year at market exchange rates by 2015. Although GDP per head will still be relatively low by the end of the forecast period, at just under US$10,000 a year, this will represent a substantial improvement from just under US$4,500 in 2010. Significant regional disparities within China will persist. The provinces of the eastern seaboard enjoy standards of living well above the national average. However, there are also markets to be found in inland China, where many large cities are located. To some extent, the size of the population and the pace of economic growth belie the challenges of operating in China. Nationwide distribution networks will increasingly be put in place, but the Chinese market is likely still to be a fragmented one by 2015.

Market opportunities for foreign companies in China are greatest in those sectors where domestic enterprises are weak, markets are underdeveloped and market opening is proceeding fastest. Although the government continues to ban foreign firms from a number of industries—such as broadcasting and armaments—or to restrict their involvement, overseas companies continue to find numerous business opportunities in a wide range of sectors across the economy. Market opportunities are opening up for companies that can advance the government's strategic objectives either within or outside the country. Chinese enterprises are also looking for joint-venture partners in resource exploitation and infrastructure.

The Chinese government encourages both labour-intensive industries, to soak up surplus labour, and capital-intensive enterprises, which can raise the quality of the national industrial base. Foreign companies are also welcome in infrastructure. The government may shy away from imported technology where there is deemed to be a local substitute. Consumer-goods markets are more open and competitive and do not rely on government procurement.

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Overview of taxation

The long-awaited Corporate Income Tax Law took effect on January 1st 2008; it introduced universal income tax rates for both foreign and local enterprises. The law, passed at the annual full gathering of the National People's Congress (the national legislature) in March 2007, replaced the Unified Tax Law of 1991, which had provided the legal basis for preferential tax rates for foreign-invested enterprises (FIEs).

The momentum towards a unified rate was accelerated after China's entry into the World Trade Organisation in December 2001, since Chinese officials argued that WTO rules prohibit unequal tax treatment of foreign and domestic companies. And since China has emerged as a coveted investment destination, it no longer needs such incentives to attract foreign funding.

Generally speaking, the new Corporate Income Tax Law has made operating in China more expensive for FIEs. It introduced a new, uniform 25% taxation rate; prior to the law, many FIEs enjoyed preferential treatment, paying rates as low as 15%. In contrast, domestic Chinese companies had faced a 33% tax rate under the old system—though far from all actually paid this high rate. Lowering that rate to the new unified 25% makes the domestic companies more competitive.

The State Council, or Cabinet, in December 2007 passed the Detailed Implementation Regulations for the Corporate Income Tax Law, which the State Administration of Taxation (SAT) and the Ministry of Finance prepared. On December 26th 2007 the State Council issued a special tax circular specifying the grandfathering regulations for companies previously paying tax at 15%; accordingly, these companies paid 18% in 2008, 20% in 2009 and 22% in 2010; they will pay 24% in 2011 and 25% in 2012.

Even after the release of the Detailed Implementation Regulations, FIEs complained that there was still less than full clarity about the ramifications of the new tax regime. It is likely that the holes will gradually be filled in as new rules are announced. However, the laws would seek to simplify existing, often extremely complex rules that gave preferential treatment to foreigners.

The Corporate Income Tax Law provides that a preferential 15% tax rate will apply to high- and new-technology enterprises, regardless of whether they are foreign or domestic. The Detailed Implementation Regulations issued in December 2007 stipulate that ownership of "core proprietary intellectual-property rights" is crucial for qualifying for the preferential rate. This could be a potential problem since, according to PricewaterhouseCoopers, a consultancy, "it is not common for multinational companies to transfer ownership of their core intellectual-property rights to their Chinese subsidiaries due to various reasons including intellectual-property protections concerns."

In a related measure, the Detailed Implementation Regulations specify special income tax incentives for venture-capital firms that invest in unlisted high- and new-technology enterprises. Following two years of investment, the venture-capital firm can offset 70% of the invested amount against its taxable income.

A preferential 20% tax rate applies for small enterprises with modest profits, as long as they do not engage in economic activity prohibited or restricted by the authorities, according to the Detailed Implementation Regulations. Industrial enterprises qualify for this category if they have annual

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income of less than Rmb300,000, total assets of no more than Rmb30m and fewer than 100 employees. For non-industrial enterprises, the criteria are annual income of less than Rmb300,000, total assets of no more than Rmb10m and fewer than 80 employees.

The Detailed Implementation Regulations permit companies to deduct against taxable income 150% of research-and-development expenditures. Similarly, they may deduct 100% of salaries to handicapped staff. For income earned from the transfer of technology, the first Rmb5m is tax exempt, whereas a 12.5% tax applies on the remainder.

Certain tax holidays remain in place even under the new laws and are open to both foreign and domestic enterprises. For example, the State Council, the Ministry of Finance and the State Administration of Taxation issued Circular 1 in February 2008, providing incentives that include the following:

- Newly established software companies enjoy a two-year tax holiday and a 50% reduction of tax payment of three years, which begins from the first year of profitability.

- Integrated-circuit makers with investment of more than Rmb8bn and an operation period of at least 15 years can enjoy a five-year tax holiday followed by a 50% reduction in tax payments for five years.

Apart from the Corporate Income Tax Law, enterprises in China continue to operate under a system introduced in January 1994. The system includes indirect taxes that apply to both local enterprises and FIEs, and also value-added, business and consumption taxes.

The State Administration of Taxation (SAT) and its provincial and municipal offices administer China's tax policies. The SAT and the Ministry of Finance together develop tax legislation and policy. Each locality in China boasts a state tax bureau under the SAT and a local tax bureau under the local government. This arrangement seeks to improve control over tax administration, and it represents a compromise between the central and local governments on the issue of sharing tax revenue.

The SAT and other government agencies have long tried to strengthen regulations and combat tax evasion. For example, the SAT issued rules, implemented on March 1st 2003, to reduce tax evasion by companies going through debt restructuring. If an indebted company, as part of a restructuring agreement with the creditor, pays back less than the full taxable value of the debt, the difference must be treated as taxable income. FIEs face suspicions that they engage in widespread tax fraud by transferring their profits overseas or by over-reporting their losses.

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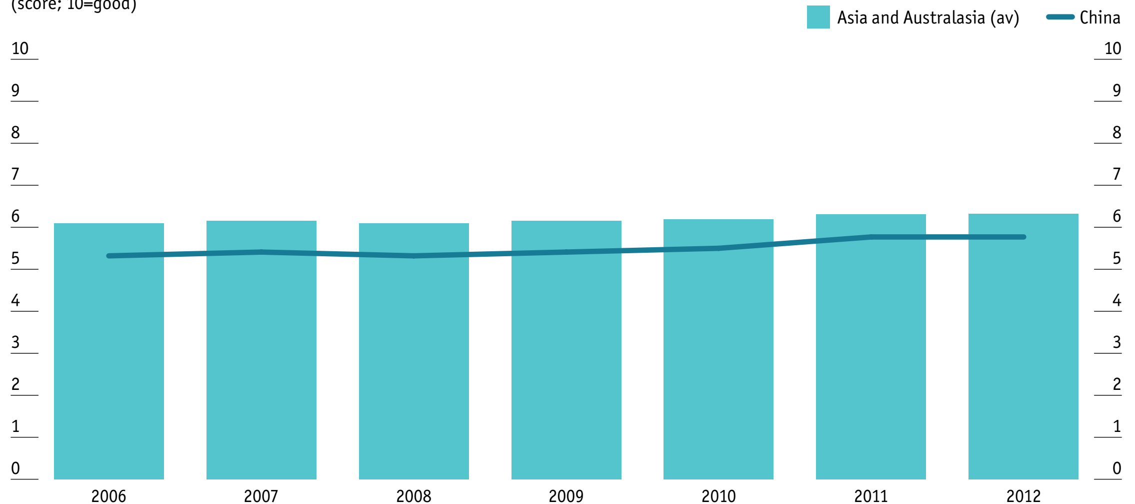

Source: Economist Intelligence Unit.

Corporate tax rates

Under the Corporate Income Tax Law implemented on January 1st 2008, the basic income tax rate that applies to foreign and domestic enterprises is 25%, with some enterprises eligible for preferential rates in certain circumstances. The new law will gradually phase out the preferential tax rates that foreign enterprises have enjoyed, mainly by virtue of having foreign ownership.

High- and new-technology enterprises, regardless of whether they are foreign or domestic, face a preferential 15% tax rate. In a related measure, the Detailed Implementation Regulations specify special income tax incentives for venture-capital firms that invest in unlisted high- and new-technology enterprises. Following two years of investment, the venture-capital firm can offset 70% of the invested amount against its taxable income.

A preferential 20% tax rate applies for small enterprises with modest profits, as long as they do not engage in economic activity prohibited or restricted by the authorities. Industrial enterprises qualify for this category if they have annual income of less than Rmb300,000, total assets of no more than Rmb30m and fewer than 100 employees. The criteria for non-industrial enterprises are annual income of less than Rmb300,000, total assets of no more than Rmb10m and fewer than 80 employees.

The Detailed Implementation Regulations permit companies to deduct from taxable income 50% of research-and-development expenditures. Similarly, they may deduct 100% of expenditures in the form of salaries to handicapped staff. For entertainment expenditures, 60% is deductible, but only up to an amount equal to 0.5% of sales income of the year. Advertising expenditures are deductible, up to an amount equivalent to 15% of business income of the year.

Certain tax holidays will remain in place even under the new laws and will be open to both foreign and domestic enterprises. For example, the State Council, the Ministry of Finance and the State

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Administration of Taxation issued Circular 1 in February 2008, providing the following incentives:

- Newly established software companies enjoy a two-year tax holiday and a 50% cut in taxes for three years, counting from the first year of profitability.

- Integrated-circuit makers with investment of more than Rmb8bn and an operation period of at least 15 years can enjoy a five-year tax holiday followed by five years with a 50% reduction in tax payments.

The new tax regime will probably phase out other regulations from the past taxation regime, such as special privileges for high-tech companies, since the new rules on high- and new-technology enterprises have superseded them. However, grandfathering rules will ensure that they not disappear all at once.

Prior to the 2008 Corporate Income Tax Law, FIEs in specific areas paid income tax at a reduced rate of 24%; this applied to holiday-spending areas, coastal open cities and areas, open cities along rivers, open cities near borders and provincial capitals in the central parts of China. All of these FIEs had to begin paying tax at 25% from January 1st 2008, when the new law took effect.

Since January 1st 1994 representative offices have been subject to a business tax of 5% on gross income sourced in China and an enterprise income tax of 33% (15% for representative offices in special economic zones).

Foreign companies had criticised the lack of transparency and overly complex rules on taxation of representative offices, and the SAT issued new rules on July 1st 2003 to address the issues. The rules divided representative offices into the following three categories:

- companies engaged in commercial, legal, tax, accounting, auditing, consulting and services are taxed on their actual income;

- companies engaged in trade and trade-agency operations are taxed on a cost-plus basis; and

- all companies not in the two first categories are taxes on actual income.

The SAT clarified the 2003 rules twice in 2004, in May and in June. The most welcome revision was to reinstate tax-exempt status for representative offices that are principal suppliers for affiliated manufacturing operations. More generally, the following income received is now subject to tax:

- commissions, rebates or handling charges for services performed (including acting as liaison during negotiations or introducing business deals) by representative offices acting on behalf of their head offices or as agents for overseas principals;

- rewards or periodic fixed fees based on the volume of commissioned services for services performed by representative offices for their clients (including clients of their head offices); and

- commissions, rebates or handling charges for services provided by representative offices for acting as agents for other enterprises in China or for assisting with negotiations or engaging in middleman services.

The following activities are exempt from tax:

- providing market surveys and business information or providing business liaison and consultation where no business or service income is received;

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- acting as an agent for a Chinese enterprise outside China, with most of the activities conducted outside the country; and
- acting as representative offices set up by foreign governments, non-profit organisations or civil bodies engaged in non-taxable activities.

Article 4 of the unified tax regulations defines arrangements through business agents, as do double-tax treaties signed by China with various foreign countries. Although the tax-regulations' definition does not differentiate between dependent and independent agents, use of an independent agent by a foreign company does not constitute a permanent establishment.

Corporate taxation, 2011

China's Corporate Income Tax Law took effect from January 1st 2008. The following are two illustrations of the tax burden for an enterprise in China established after January 1st 2008. (For convenience, the amounts are in units of 1,000, which could apply to renminbi or dollars.) The first applies to an enterprise engaged in production, the second to an enterprise engaged in a non-production activity that is a payer of business tax.

	Year 1	Year 2	Year 3	Year 4	Year 5
Turnover (VAT exclusive)a	1,000	2,000	3,000	4,000	5,000
Profits before taxes	100	200	300	400	500
Production enterprise					
Income tax (25%)	25	50	75	100	125
Profits after taxes	75	150	225	300	375
Retained earnings, brought forward	0	75	25	0	100
Dividend distribution	0	200	250	200	0
Withholding income tax on dividend (10%)b	0	20	25	20	0
Retained earnings, carried forward	75	25	0	100	475
Non-production enterprise					
Business tax (at an assumed rate of 5%)c	50	100	150	200	250
Profits after business tax but before income tax	50	100	150	200	250
Income tax (25%)	12.5	25	37.5	50	62.5
Profits after taxes	37.5	75	112.5	150	187.5
Retained earnings, brought forward	0	37.5	12.5	25	25
Dividend distribution	0	100	100	150	0
Withholding income tax on dividend (10%)b	0	10	10	15	0
Retained earnings, carried forward	37.5	12.5	25	25	212.5

(a) Value-added tax (VAT) is calculated on sale price and payable by purchasers. Export sales for most products are zero rated, but VAT on domestic inputs, if any, may not be fully refunded upon export. Any non-refundable portion is treated as costs of the enterprise. (b) Withholding income tax on dividends is 10% under China's domestic tax law, which may be reduced under a tax treaty, if applicable. (c) Business tax is calculated based on turnover.

Source: PricewaterhouseCoopers, Hong Kong.

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Taxable income defined

The taxable income of a foreign-invested enterprise (FIE) is defined as the amount remaining from its gross income in a tax year after deducting allowable expenses and losses. All documented costs are allowable except those expressly identified as non-deductible.

Non-deductible expenses include the following: costs to purchase or construct fixed assets; costs incurred on gains obtained through assignment or developing intangible assets; various income taxes paid; interest on capital; late-payment surcharges and fines incurred for various income tax payments; fines incurred for unlawful operations and losses sustained through the confiscation of property; losses from windstorms, fire and other natural disasters covered by insurance indemnity; donations and contributions other than those for public welfare and relief purposes; royalties paid to the head office; and the portion of entertainment expenses either exceeding established quotas or not relevant to production and operations.

Foreign taxes levied on FIEs in China may be credited against Chinese corporate taxes. Interest on loans made to the Chinese government or Chinese state banks may be exempt from tax. Losses incurred by an FIE may be carried forward for five years; no carry-back is permitted.

Depreciation

According to the Detailed Implementation Regulations for the Corporate Income Tax Law, issued in December 2007, depreciation via the straight-line method is deductible and subject to minimum depreciation periods. These range from 20 years for buildings and structures, ten years for aircraft, trains and machinery, to three years for electronic equipment. Special depreciation rules apply for foreign-invested enterprises engaged in oil and gas exploration; the Ministry of Finance and State Administration of Taxation in April 2009 issued a circular setting a minimum eight-year depreciation period for oil and gas enterprises.

Treatment of capital gains

The Detailed Implementation Regulations, released in December 2007, on the Corporate Income Tax Law of 2008 set a basic withholding tax rate of 10% on capital gains on income sourced in China. This also applies to net gains from the transfer of shares or equity interests in enterprises in China held by foreign-invested enterprises (FIEs) and from the transfer of shares in enterprises in China held by establishments or sites set up by FIEs in China. In December 2005, however, the State Administration of Taxation and the Ministry of Finance made qualified foreign institutional investors (QFIIs) exempt from taxes on the capital gains of their securities holdings in order to encourage more international demand for China's equity and debt. A provisional exemption from withholding tax applies to net

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gains from a transfer by an FIE or foreign national of B-shares or shares in a Chinese enterprise listed overseas (such as in Hong Kong or New York).

For gains on real property net of development costs, the Real-Property Gains Tax (RPGT) Provisional Regulation, implemented on January 1st 1994, introduced the following tax rates: zero for the portion of gains equalling up to 20% of the original purchase price; 30% for gains equalling up to 50%; 40% for gains equalling 51–100%; 50% for gains equalling 101–200%; and 60% for gains exceeding 200%.

The Ministry of Finance released implementing regulations for the RPGT in January 1995: Detailed Implementing Rules for the Provisional Regulations of China Concerning Land Value-Added Tax. These rules outline certain permissible deductions to calculate added value. The rules note that China will not levy taxes on real-property projects where agreements were reached before January 1st 1994. Exemption from property tax is also allowed where the property transfer is an owner-occupied residential unit and the resident has lived there more than five years. There is a half-exemption for those who have occupied a site for more than three years; those occupying a site for less time are subject to full tax. RPGT applies to all types of land, structures and immovable property, including commercial, industrial and residential sites.

The tax regime provides for expense deductions and additional allowances, which help to alleviate the effect of the RPGT on projects begun after January 1994. The implementing regulations provide for the full deduction of financing expenses and limited deductions for administration and selling expenses. Nonetheless, the tax regime applies a 5% business tax on the sale price of property and the standard 25% corporate profits tax. Hence, the effective tax on property income, despite allowable deductions, is close to 50%.

Because RPGT is a source of revenue for local governments, a foreign investor can sometimes negotiate a refund with a local government before committing to new projects. And since this is a transactional tax, there may be some flexibility in administration and collection procedures. But developers should proceed carefully and plan their tax structures assiduously to avoid exposing their projects to added tax liabilities.

Taxes on interest and dividends

As from October 9th 2008, the State Council abolished a 5% tax on interest income from savings accounts—to raise disposable incomes and boost domestic demand. The interest tax had earlier been reduced from 20%, in August 2007.

The 2008 Corporate Income Tax and the Implementing Regulations make clear the abolition of the tax exemption that was in place for dividends paid to foreign investors from profits in a foreign-invested enterprise, whether it is a wholly-foreign-owned enterprise or a joint venture. The 10% withholding tax applies, according to the Implementing Regulations.

The State Administration of Taxation issued a regulation in December 2008, retroactive from January 1st 2008, imposing a 10% tax on interest earned by foreign banks lending to banks in China

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Taxes on royalties and fees

A circular from the State Administration of Taxation (SAT) issued in late 1998 encourages non-residents to make early payment of taxes on interest, rent and royalties. Specifically, it states that non-residents must pay withholding tax during the period when interest, rent or royalties by a local party is payable according to the terms of the contract. This holds even if the local party has not paid interest, rent or royalties to the non-resident, and it has simply been accrued or expensed for accounting purposes. The withholding tax rate on royalties and fees resulting from the licensing of trademarks, copyrights, know-how and technical treaties is now generally 10%.

Under the Business Tax Law of 1994, technology transfers are subject to a business tax of 5% if the transfers are not made by establishments in China. An SAT circular from January 1998 reinforced this rule, saying the 5% business tax applies to royalties and is to be deducted, along with withholding tax, from gross royalties by the transferee before paying the foreign transferor.

In April 2005 the SAT released a circular that stipulated new procedures on examining and approving applications for reduction or exemption of the 5% tax for royalties involved in technology import. Foreign companies can now apply for a tax reduction or exemption if the technology involved is considered advanced. The procedure aims to encourage the import of technology and to standardise the procedures for such tax reduction and exemption.

Double-tax treaties

By January 2011 China had signed and ratified agreements with 90 foreign governments. It had also signed double-tax agreements with the special administrative regions Hong Kong and Macau. The State Administration of Taxation issued a notice on April 13th 2001 to help foreign enterprises and individuals avoid double taxation. Under it, tax bureaux at all levels must issue the residence certificates needed by foreign enterprises and individuals. Although this does not change the criteria under which foreigners are classified as taxpaying residents of China, it helps them provide the necessary records to avoid double taxation—in both China and their home countries.

China and the Hong Kong Special Administrative Region signed a double-taxation agreement in February 1998. Under it, the Chinese side does not tax a Hong Kong enterprise's gains from transport business in China, and vice versa. The arrangement also affected personal income taxes.

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Withholding tax rates under double-tax treaties (%)

Country of recipient	Dividends	Interest[a]	Royalties[b]	Country of recipient	Dividends	Interesta	Royaltiesb
Albania	10	10	10	Macedonia	5	10	10
Algeria	10/5 c	7	10	Malaysia	10	10	15m/10
Armenia	10/5 c	10	10	Malta	10	10	10
Australia	15	10	10	Mauritius	5	10	10
Austria	10/7 d	10/7k	10/6	Mexico	5	10	10
Azerbaijan	10	10	10	Moldova	10/5 c	10	10
Bahrain	5	10	10	Mongolia	5	10	10
Bangladesh	10	10	10	Morocco	10	10	10
Barbados	10/5 c	10	10	Netherlands	10	10	10/6
Belarus	10	10	10	New Zealand	15	10	10
Belgium	10	10	10/6	Nigeria	7.5	7.5	7.5
Brazil	15	15	25/15l	Norway	15	10	10
Brunei	5	10	10	Oman	5	10	10
Bulgaria	10	10	10/7	Pakistan	10	10	12.5
Canada	15/10h	10	10	Papua New Guinea	15	10	10
Croatia	5	10	10	Philippines	15/10i	10	15m/10
Cuba	10/5c	7.5	5	Poland	10	10	10/7
Cyprus	10	10	10	Portugal	10	10	10
Czech Republic	10	10	10	Qatar	10	10	10
Denmark	10	10	10/7	Romania	10	10	7
Egypt	8	10	8	Russia	10	10	10
Estonia	10/5c	10	10	Saudi Arabia	5	10	10
Finland	10/5c	10	10/7	Seychelles	5	10	10
France	10	10	10/6	Singapore	10/5 c	10/7k	10/6
Georgia	10/5/0e	10	5	Slovakia	10	10	10
Germany	10	10	10/7	Slovenia	5	10	10
Greece	10/5 c	10	10	Sri Lanka	10	10	10
Hong Kong SAR	10/5f	7	7	South Africa	5	10	10/7
Hungary	10	10	10	South Korea	10/5 c	10	10
Iceland	10/5 c	10	10/7	Spain	10	10	10/6

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Withholding tax rates under double-tax treaties (%) cont...

Country of recipient	Dividends	Interest[a]	Royalties[b]	Country of recipient	Dividends	Interesta	Royaltiesb
India	10	10	10	Sudan	5	10	10
Indonesia	10	10	10	Sweden	10/5 c	10	10/7
Iran	10	10	10	Switzerland	10	10	10/6
Ireland	10/5 d	10	10/6	Tajikistan	10/5 c	8	8
Israel	10	10/7 k	10/7	Thailand	20/15f	10	15
Italy	10	10	10/7	Trinidad and Tobago	10/5 g	10	10
Jamaica	5	7.5	10	Tunisia	8	10	10/5 n
Japan	10	10	10	Turkey	10	10	10
Kazakhstan	10	10	10	Ukraine	10/5 c	10	10
Kuwait	5	5	10	United Arab Emirates	7	7	10
Kyrgyz Republic	10	10	10	United Kingdom	10	10	10/7
Laos	5	5 (in Laos)	5 (in Laos)	United States	10	10	10/7
		10 (in China)	10 (in China)	Uzbekistan	10	10	10
Latvia	10/5 c	10	10	Venezuela	10/5 j	10/5 k	10
Lithuania	10/5 c	10	10	Vietnam	10	10	10
Luxembourg	10/5 c	10	10/6	Yugoslavia	5	10	10
Macao SAR	10/5 c	7	7	Non-treaty countries	10	10	10

Note: This table is a summary and does not reproduce all the provisions relevant to apply withholding taxes in each tax treaty. Besides the above tax treaties, some of these countries have entered into investment-protection treaties with China.
(a) Nil on interest paid to government bodies except for Australia, Brunei, Cyprus, Israel, Slovenia and Spain. Reference should be made to the individual tax treaties. (b) The lower rate on royalties applies for the use of or right to use any industrial, commercial or scientific equipment. Reference should be made to the individual tax treaties. (c) The lower rate applies where the beneficial owner of the dividend is a company (not a partnership) that directly owns at least 25% of the capital of the paying company. (d) The lower rate applies where the beneficial owner of the dividend is a company that directly owns at least the paying company. (e) The lowest rate (that is, 0%) applies where the beneficial owner is a company that owns directly or indirectly at least 50% of the capital of the paying company and the investment exceeds €2m. The lower rate (that is, 5%) applies where the beneficial owner is a company that directly or indirectly owns at least 10% of the capital of the paying company and the investment exceeds €100,000; (f) The lower rate applies where the beneficial owner of the dividend is a company that directly owns at least 25% of the capital of the paying company. (g) The lower rate applies where the beneficial owner of the dividend is a company that directly or indirectly owns at least 25% of the capital of the paying company. (h) The lower rate applies where the beneficial owner of the dividend is a company that owns at least 10% of the voting shares of the paying company. (i) The lower rate applies where the beneficial owner of the dividend is a company that directly owns at least 10% of the capital of the paying company. (j) The lower rate applies where the beneficial owner is a company (other than a partnership) which directly owns at least 10% of the capital of the paying company. (k) The lower rate applies to interest payable to banks or financial institutions. (l) The higher rate applies to trademarks. (m) The higher rate applies to copyright of literary, artistic or scientific work including cinematographic films or tapes for television or broadcasting. (n) The lower rate applies to royalties paid for technical or economic studies or for technical assistance.
Source: PricewaterhouseCoopers, Hong Kong.

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Intercompany charges

The Unified Tax Law of 1991 plugged loopholes involving transfer pricing. It did this by requiring foreign-invested enterprises (FIEs) to conduct business transactions with affiliated companies at arm's length (that is, as if with an unrelated company). To verify this treatment, FIEs must regularly submit accounts to the local taxation bureau. Where intercompany charges or fees do not reflect an arm's-length arrangement, tax authorities may make compensatory adjustments by reference to normal market rates or prices for similar services or goods.

The State Administration of Taxation (SAT) promulgated rules in April 1998 on taxing business dealings between affiliated enterprises. Those rules specify what constitutes affiliated enterprises, such as when one company holds at least 25% of another's shares or when one company appoints more than half of another's board. The rules say tax authorities should particularly target companies that have reported losses for more than two years and companies that engage in business with each other inside duty-free ports.

The government has become stricter about transfer pricing. The Corporate Income Tax Law applicable from January 1st 2008 gave the taxation agencies greater authority to intervene in irregularities, allowing them to make adjustments if a tax-paying company has entered into an arrangement "without reasonable commercial purpose".

The SAT issued a notice on April 23rd 2003 allowing tax authorities to levy tax retroactively on transactions between affiliated companies that took place up to ten years in the past—though certain circumstances must apply for the ten-year retroactive period to apply. These conditions include instances where transactions led to an increase of taxable income of at least Rmb500,000 or where the affiliated company is in a tax haven.

The SAT had last addressed this problem in a circular on May 20th 1998, which set out rules on transfer pricing. This circular on Tax Administration Rules and Procedures for Transactions between Related Parties consolidated many existing regulations, added new provisions and superseded all conflicting rules. Overall, it aimed to modernise policing of transactions by multinational companies while harmonising regulations with international standards. Its 52 articles define "related enterprises", the factors that may lead a company to be audited and the methods the SAT can use to calculate the proper level of transfer payments. The circular directed provincial tax bureaux to establish specialist audit teams, and it requires Chinese tax authorities to share tax information with one another.

Turnover, sales and excise taxes

China implemented a value-added tax (VAT) and a business tax on January 1st 1994 to replace the industrial consolidated and commercial tax (a turnover tax levied on the transfer or sale of goods and services). This system is changing as part of a general overhaul of the tax system.

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Value-added tax (VAT) applies at a rate of 17% to the value of products at importation and wholesale and retail sale. A 13% rate applies to some goods, such as grains, vegetable oils, books and utilities. Beginning January 1st 2009, China extended a reform of the VAT system from certain trial areas to cover all industries across the nation. Under the VAT reform, companies can use fixed-asset spending to offset sales.

Also with effect from January 1st 2009, the VAT rate paid by small enterprises fell from 6% to 4% for commercial companies and 3% for industrial companies. ("Small enterprises" are those engaged in manufacturing or providing labour services with sales not exceeding Rmb1m, and those engaged in wholesale or retail trade with sales not exceeding Rmb1.8m.)

The Provisional Regulations on Value-added Tax also were implemented from January 1st 2009. They abolished previous VAT exemptions that foreign-invested enterprises (FIEs) had enjoyed for imported equipment used to upgrade technology. The rules also abolished a VAT-refund policy for domestically produced equipment acquired by FIEs.

As the financial crisis began to affect China more severely towards the end of 2008, the government expanded the use for rebates available to exporters as refunds for VAT paid in the production process. The rebate rates vary by the specific product.

Business tax, instead of VAT, applies to services including construction, entertainment, insurance, posts and telecoms, real-property broking, transport and the assigning of intangible assets such as copyrights, land-use rights, patents, trademarks and the sale of immovable property. The tax excludes processing, repair and replacement services, which are subject to VAT. The business tax is either 3% or 5% for most sectors except the entertainment business (which is taxed at 20%). New regulations on the business tax, from January 1st 2009, make it possible to levy the tax even if the transaction is performed outside China, as long as the entity liable for payment is within China's borders.

Enterprises operating within the service sectors and liable for business tax have no mechanism to claim VAT credit for inputs of goods subject to VAT. Unlike VAT, no credit is granted for business tax paid. Tax paid on services received or properties acquired may not be deducted from business tax payable. But deductions are allowed in certain designated industries.

Taxpayers engaged in business activities relating to more than one taxable category are required to account separately for taxable items; otherwise, the highest tax rate applies. This applies to a company that sells goods chargeable to VAT and provides after-sales services subject to business tax. If a company cannot account separately for these activities, it will face the higher 17% VAT rate. Such companies should set up different profit centres for each activity and maintain separate accounting records and invoicing systems.

Consumption tax of 3–45% has applied since January 1994 to the following goods: alcohol, cosmetics, diesel fuel, fireworks, hair- and skin-care products, jewellery, motorcycles, motor vehicles, petrol and tobacco. The tax, meant to discourage excessive consumption of these goods, affects mainly those companies involved in producing or importing them. The State Council adjusted the consumption tax rate on cigarettes in 1998, raising it to 50% for deluxe categories. Exports are exempt from consumption tax.

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Other taxes

Foreign business operations may be assessed other taxes.

Licence tax can apply at the discretion of local authorities on vehicles and vessels belonging to individuals and enterprises. Tax rates vary by tonnage for boats, Rmb0.60–5 per tonne, and by type and size for vehicles, Rmb1.20–320 per unit.

Stamp tax, ranging from 0.005% (for loan agreements) to 0.1% (for warehousing and storage contracts and also for property insurance contracts), applies to contracts, written certificates of property-rights transfer, business account books and permits.

Local taxes. A building property tax applies annually on the owner or user of a property at 1.2% of assessed value or 12% of rentals for leased property. The tax applies to Chinese legal entities, including foreign-invested enterprises (FIEs) and individual citizens. A local land-use tax applies, at varying rates depending on the size of the city or locale. All enterprises (including FIEs) incur a city and county maintenance and construction tax.

In January 2011, the cities of Chongqing and Shanghai announced taxes on luxury property in a measure that could gradually be expanded to other parts of China. The taxes, which took effect immediately, were meant to cool the real-property market. In Chongqing, the tax is 0.5–1.2% of the transaction price of all apartments and villas priced at twice the local average or more.

Natural resources tax. A National Resources Law, implemented on January 1st 1994, outlines tax rates for enterprises and individuals engaged in exploiting mineral products or producing salt. Rates for crude oil are Rmb8–30 per tonne; natural gas, Rmb2–15/1,000cu metre; coal, Rmb0.30–5/tonne; other non-metal minerals, Rmb0.50–20/tonne; ferrous-metal mineral mining, Rmb2–30/tonne; and non-ferrous-metal mineral mining, Rmb0.40–30/tonne. Tax liability arises on receipt or proof of payment, and the tax is payable to local authorities at the place of production or exploitation. In June 2010 China introduced a 5% tax on the sale of crude oil and natural gas in its westernmost Xinjiang region. The China Daily newspaper reported in January 2011 that the tax will cover all of China by 2015.

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