

## CHINESE TAX SYSTEM

Chinese tax system is relatively new. Primarily concerned by domestic enterprises, China's tax system has been reformed during the 1980s, in order to regulate also foreign enterprises and foreign invested enterprises. There is no single tax law or code governing the taxation of enterprises in China. There is a basic law giving the broad principles of each tax. Details are provided by implementing regulations and specific rules in the form of circulars issued by the State Administration of Taxation (SAT) or the Ministry of Finance (MOF). The language of the law is Chinese and if laws have been translated, Chinese version is the most authoritative one. China's tax administration is characterized by the important discretionary power given to the local authorities. The regulation-making is not strictly centralized.

There are 24 taxes in China, which can be classified into the seven categories: turnover, income, resource, property and behavior, prescribed items, agriculture and custom taxes. Main China's taxes can be simplified as follows:

### ▪ **Enterprise Income Tax:**

<b>Liability to tax</b>	<b>Taxable basis</b>	<b>Tax rates</b>
-Resident enterprises: For worldwide income	Income derived from: -sales of goods -rendering of services	Standard income tax rate: 25%
-Foreign enterprises with Establishment in China: For income carried out in Connection with this Establishment	-transfers of properties -other sources (dividends, Interest, leasing income, Royalties, subsidies...)  Except exemptions	Recognized high and new tech enterprise: 15%  Small-scale enterprises under specific conditions: 20%
-Foreign enterprises without Establishment in China: For income derived from within China		

### ▪ **Turnover taxes:**

<b>Type</b>	<b>Tax basis</b>	<b>Tax rates</b>

Value-added tax (VAT)	Enterprises engaged in the: -Sale of goods -Provision of processing, Repairs and replacement Services -Importation of goods	Standard rate: 17%  Reduced rate for specific products: 13%  Small businesses under specific conditions: 4-6%
Business tax	Enterprises engaged in the provision of taxable services (transportation, construction, financial and insurance, post and telecommunications, cultural and sports, Entertainment...)	3% -20% depending on the service category
Consumption tax	Enterprises engaged in manufacturing, commission processing or importation of luxury consumer goods	3%-45% depending on the product

▪ **Property and behavior taxes:**

Type	Tax basis	Tax rates
Stamp duty	Enterprises that conclude or receive specified documents protected under PRC Laws (various types of contracts,	Depends on the type of document

	business books and accounts...)	
Deed tax	Tax imposed on assignment or transfer of the ownership title of the land use rights and/or the buildings	Generally, rate is between 3 to 5% of the transaction price or the value if the assignment or transfer
Land VAT	Enterprises that realize gains on the assignment or transfer of land use rights, buildings and the associated structures thereon within the territory of China	Calculated on the added value gained by the taxpayer through the assignment of real estate
Real estate tax	Tax imposed on the owner of mortgage of the real estate	Calculated based on the deemed standard values of the land and buildings or the rental income
Resource tax	Enterprises engaged in the extraction of certain mineral products and natural resources or salt production within China	Depends on the type of product

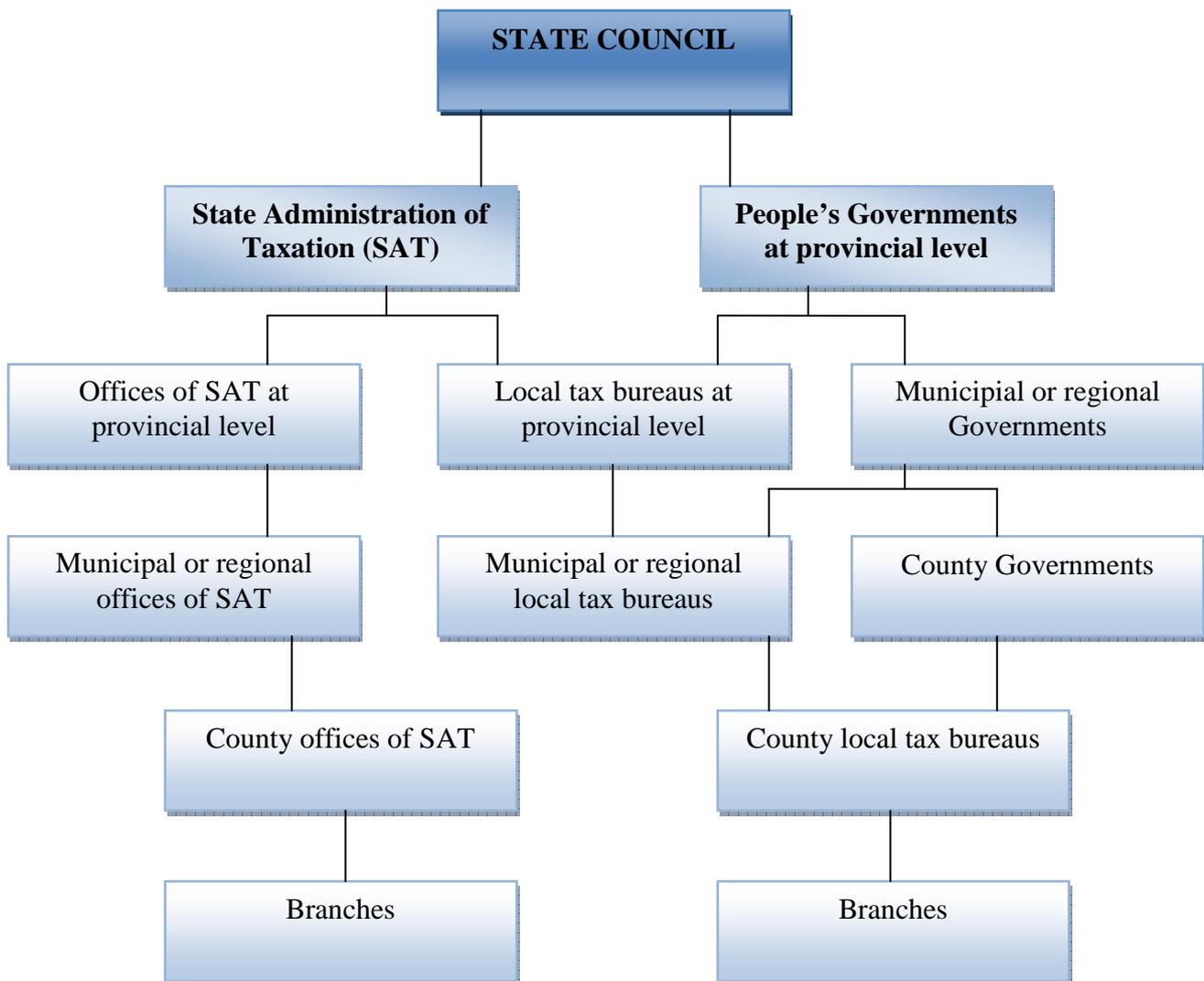
### **TAX AUTHORITIES**

Tax authorities in China are composed of The State Administration of Taxation (SAT), the Ministry of Finance (MOF) and local tax authorities. The SAT is the highest tax authority in China. It is responsible of drafting tax laws, consulting to the State Council on tax policy, formulating implementation procedures and supervising the local tax bureaus which are established as provincial and municipal levels. The MOF is responsible for formulating implementation procedures and for controlling State budget.

The State Council is responsible for the collection and administration of taxes generating revenue for the central government or revenue shared between the central and local governments.

Local tax bureaus have to follow the direction of the SAT. They are responsible for collecting taxes generating revenue for the respective local governments. The major part of decisions affecting taxpayers is made at such a level. Local tax bureaus are therefore the first interlocutors of taxpayers. There is often an important disparity in the practices of each tax bureau. A very local specific tax advice should be asked and a taxpayer should not rely too much upon the national legislation.

Chinese tax Administration organization:



## ENTERPRISE INCOME TAX

Foreign enterprises and foreign invested enterprises were subject to a different tax law before 2008. They benefited from a lower enterprise income tax rate and generous tax incentives. The Enterprise Income Tax Law (EITL) and the Enterprise Income Tax Implementing Rules (EITIR), which come into effect on 1 January 2008 have unified tax treatment of domestic and foreign enterprises and enterprise income tax rate.

### ▪ **Taxpayers:**

The EITL introduces the concept of tax resident enterprises and tax non resident enterprises. A “resident enterprise” is an enterprise established in China, or an enterprise that is established in a foreign company but whose actual management or control is located in China. A “non resident enterprise” is an enterprise that is established in a foreign country and whose actual control is located outside China but which has an establishment in China or that does not have an establishment in China but derives income from sources within China.

Actual management means a department which exercises overall management and control over the manufacturing and operations, employees, finance and property of the enterprise.

An establishment is defined as:

- A place of management, operation or administration;
- A farm, factory or place of extraction of natural resources;
- A place where services are rendered;
- A place of construction, installation, assembly, repair and exploitation, etc;
- Other establishments engaged in manufacturing and business operating activities

### ▪ **Taxable income:**

A resident enterprise should pay Enterprise Income Tax for its worldwide income. Foreign enterprises with establishment in China are taxable for income carried out in connection with this establishment. Foreign enterprises without establishment in China should pay enterprise income tax on income derived from within China.

The amount of enterprise income tax payable is calculated according to the following formula:

$$\text{Taxable income} = \text{Enterprise's total income} \times \text{applicable enterprise income tax rate} - \text{tax deduction amount} - \text{tax exemption amount} - \text{remedies for losses of the previous year}$$

An enterprise's total income amount refers to the monetary and non-monetary incomes and including:

- income from selling goods;
- income from providing labor services;
- income from transferring property;
- equity investment gains, such as dividend, bonus;
- interest incomes;
- rental income;
- royalty income;
- income from accepting donations; and
- other incomes.

The above money forms of income include cash, deposits, receivable amounts, receivable instruments, bond investments to be held until maturity and waiver of debts, etc. Non-money forms of income refer to fixed assets, biological assets, intangible assets, equity investments, and inventories, bond investments not to be held until maturity, labor services and relevant interests.

▪ **Tax preferences:**

Tax preferences are provided for specific income and qualified tax payers, including tax-free income, tax-exemptible income, tax deductible income and low tax rate.

The following income is tax-free:

- Financial allocation;
- Administrative public charge or government fund;
- Other tax-free income stipulated by the State Council.

The following income is tax-exemptible income:

- The interest incomes from treasury bonds;
- Dividends, bonuses and other equity investment gains generated between qualified resident enterprises;
- Dividends, bonuses and other equity investment gains which are obtained from a resident enterprise by a non-resident enterprise with organs or establishments inside the territory of China and have actual connection with such organs or establishments;
- Incomes of qualified not-for-profit organizations.

The following income may be exempted or reduced:

- The incomes generated from the engagement in agriculture, forestry, husbandry and fishery;
- The incomes generated from investment in and business operations of the important public infrastructure projects supported by the state;
- The income generated from the projects of environmental protection, energy and water saving and satisfying the related requirements;
- The incomes generated from transferring technologies and satisfying the related requirements; and
- The income derived from China and received by a non-resident enterprise without an establishment in China, or by a non-resident enterprise with an establishment in China but the above income without any de facto relationship with such China establishment.

▪ **Tax rate:**

Under the EITL, the general enterprise income tax rate is 25%. Nevertheless, a lower tax rate is applicable under the following circumstances:

Non resident enterprises not deriving income from an establishment in China:

The applicable tax rate for income derived from China and received by a non-resident enterprise without an establishment in China or without de facto relation with an establishment if it has one is 10%.

Small-scale enterprises:

Specified small scale taxpayers are entitled a lower tax rate of 20% under the following specific conditions depending on their activity sector (industrial or non industrial).

Conditions:

<b>Industrial enterprises</b>	<b>Non industrial enterprises</b>
<p>Cumulative conditions :</p> <ul style="list-style-type: none"> <li>-Enterprises engaged in industries non-restricted or prohibited by the State</li> <li>-Annual taxable income &lt; RMB 300 000</li> <li>-Total assets &lt; RMB30 million</li> <li>-Number of staff &lt; 100 employees</li> </ul>	<p>Cumulative conditions:</p> <ul style="list-style-type: none"> <li>-Annual taxable income &lt; RMB 300 000</li> <li>-Total assets &lt; RMB 10 million</li> <li>-Number of staff &lt; 100 employees</li> </ul>

High and new technology enterprises:

Enterprises designated as “high tech enterprises”, are allowed to enjoy a reduced income tax rate of 15%. According to the legislation, enterprises that can be designated as “high tech enterprises” should be registered in China at least during one year and have their activity in specified sectors:

- electronic information technology
- biotechnology and new pharmaceutical technology
- aviation technology
- new materials technology
- high-tech industry

- new energy and energy saving technology
- resources and environmental technology
- use of high-tech to transform traditional industries

Additional criterion should be respected concerning the R&D expenditure, the IP right, the revenue and the employment structure:

- The revenue coming from high tech products and services should be not less than 60% of total revenue
- The IP core for the main products or services should be acquired for the past three years or an exclusive license should be acquired for more than five years
- The amount of R&D should represent not less than 6% of the total sales revenue when it is inferior to 50 RMB million, not less than 4% for a total sales revenue of 50-200 RMB million and not less than 3% when the total sales revenue exceeds 200 RMB million
- College graduates should exceed 30% of the total number of employees and the R&D staff should be more than 10%

- **Tax adjustments:**

#### Transfer pricing

The arms length principle states that related party transactions shall respect a fair market price that would have applied if the transaction as made between two independent parties. The notion of “related party” is specified by Article 109 of the EIT Regulations. It refers to enterprises, other organizations and individuals that have any of the following relations with an enterprise:

- Direct or indirect control over such matters as finance, business, operations, sales or purchase, etc;
- Both directly or indirectly controlled by a common third party
- Other relationships due to associated interests

Tax authorities are empowered to make adjustments through “reasonable methods” if the non-arms length is not respected, and can impose interest and a 5 per cent penalty on such adjustments. A ten year limitation is imposed on the making of adjustments.

A resident enterprise can enter into an “Advance Pricing Agreement (APA) with tax authorities. Those agreements permit to avoid possible future disputes by anticipating the method for determining the transfer pricing for any related party transactions.

The most important change in China’s transfer pricing rules under the EITL is the “documentation requirements”. A contemporaneous documentation should be provided including:

- Organizational structure
- Summary of business operations
- Information about the related party transactions
- Comparability analysis
- Selection and application of transfer pricing methods

This documentation should be prepared by 31 May of the following year and maintained for ten years. Taxpayer should submit their contemporaneous transfer pricing documentation within 20 days from the date of request by the tax bureau. If a taxpayer refuses to provide documents on its related party transactions, or provides false or incomplete materials or untruthful information, the tax bureau can order to rectify the situation within a specified period and impose a fine of up to RMB50 000.

### Thin capitalization

The deduction of interest payments to a related party where the debt-to-equity ratio exceeds the “prescribed standards” is prohibited. The debt to equity ratio for financial entities is limited to 5:1 and for non-financial enterprises to 2:1. If the ratio exceeds the prescribed ratio in a year, interest payments are not deductible. The related party debt to equity ratio is defined as a portion of the debt investment received by the entity from all its related parties to the equity investment. Nevertheless, if the debt to equity ratio is exceeded, where the taxpayer can provide documentation to support that the transaction is consistent with arms length principles, the deduction is allowed. A 5% penalty tax is applied in case of any adjustment.

### Controlled Foreign Company (CFC) rule

The EITL provides that “where an enterprise that is established by a Chinese resident enterprise in a jurisdiction pays tax at a rate obviously lower than 25% and does not distribute its profits for reasons other than business needs, the amount of profit that should have been distributed to the Chinese shareholder is included in the income of the Chinese resident”. It means that tax authorities are empowered to attribute income to a resident enterprise where profits are held by a non-resident enterprise that is controlled by the resident enterprise when the following conditions are met:

- The resident enterprise “controls” a foreign enterprise.
- The tax rate in the foreign enterprise’s country is “obviously lower” than 25%.
- The non-resident enterprise has not distributed its profits; and
- The non-resident enterprise does not have reasonable business operational needs for not distributing the profits.

A resident enterprise controls a foreign enterprise if:

- The resident enterprise or Chinese resident holds, directly or indirectly, 10% or more of the voting common stock of a foreign enterprise, or jointly holds, directly or indirectly, 50% or more of the stock of the foreign enterprise; or
- The taxpayer has substantial control over the foreign enterprise with respect to equity, capital, business management, sale or purchase, etc

“Obviously lower” means 50 percent of the 25% enterprise income tax rate.

### General anti avoidance rules

The tax bureau is allowed to make an adjustment based on “reasonable methods” when an enterprise makes any arrangement not for any reasonable commercial purpose, which causes the decrease of its taxable revenue or income. ‘Not for any reasonable business purpose’ refers to an arrangement where the ‘main purpose is to reduce, exempt or defer the payment of taxes’. The tax authorities have ten years of limitations to make an adjustment.

- **Payment terms**

The tax payment place of a resident enterprise should be its registration place. For a non resident enterprise having a place of actual management in China, the tax payment place should be the location of the actual management.

## WITHHOLDING TAX

- **Taxpayers:**

Non resident enterprises without establishment in China are subject to enterprise income tax on a withholding basis for the following income derived within China:

- Dividend income and profit distributions  
(Income derived by a enterprise from its invested entities)
- Royalty income  
(Income from providing use rights for patent, non-patent technology, copyright, trademark and other license rights)
- Interest income  
(Income derived by an enterprise from provisions of funds to other parties that does not constitute equity interest)
- Rental income  
(Income derived by an enterprise for providing use rights for fixed assets, packaging materials and other tangible assets)
- Gains from transfer of assets  
(Income derived by an enterprise from the transfer of fixed assets, biological assets, intangible assets, capital investments etc...)
- Other income which may be deemed taxable income

- **Withholding tax rate:**

Withholding tax rate = **20%**

⇒ Reduced to **10%** for dividend income and profit distributions, royalty income interest income, rental income, gains from transfer of assets

⇒ Reduced by the applicable tax treaty  
Ex: Under the tax treaty between China and Italy

- Tax rate for dividends remains at **10%**
- Interest income **may be exempted**
- Tax rate for royalties in general remains at **10%**
- Tax rate for royalties on use of equipment is reduced to **7%**

The enjoyment of tax treaty benefit is conditioned by the following requirements regarding:

The non-resident enterprise (or recipient of the dividends)

- It must be a tax resident of the treaty partner jurisdiction
- It must be the beneficial owner of the dividends
- The dividend income must be regarded as a dividend or other equity income under the Chinese law
- Any other criteria stipulated by the SAT

The non-Chinese resident (or the other side)

- Should be a company
- The shareholding requirement must be met in terms of beneficial interests and voting rights
- The ownership percentage must continuously meet the requirements specified by the treaty within the 12 months before the receipt of the dividends

▪ **Administration of withholding tax:**

Procedure for Chinese source passive income (dividends, royalties, rental income, capital gains...):

<b>Withholding agent</b>	<b>Filing requirements</b>	<b>Payment</b>
Withholding agent = Payer of income items	<p>The following documents must be given by the withholding agent to the tax bureau in-charge within 30 days from the date the contract is entered:</p> <ul style="list-style-type: none"> <li>-Contract registration form for withholding tax</li> <li>-Copy of the contract</li> <li>-Other relevant documents</li> </ul> <p><u>For an offshore share transfer:</u> The non-resident enterprise must submit a copy of the share transfer agreement</p>	<p>The withholding agent must withhold the required amount of tax for each payment made to the non-resident upon the time of the actual payment made/ due or payable</p> <p><u>In case of withholding agent failure:</u> The non-resident enterprise shall report tax 7 days after actual payment made/ due to the tax authority at the location of the source of the income</p> <p><u>If income is received from different locations:</u> The non-resident enterprise must choose one for reporting</p> <p><u>In case of failure of the non-</u></p>

		<u>resident enterprise:</u> The tax authority can collect payment from other income derived from China
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Procedure for Chinese source income from construction contract projects and provision of labor services:

Tax authorities may designate the payer of the contracted amount (for engineering contracts) or labor service fee as the withholding agent under the following circumstances:

- The estimated period of the contract or the service is less than one tax year and evidence exists to show that the tax obligation will not be fulfilled
- Tax registration or temporary tax registration has not been carried out and there is no agent appointed by the non-resident enterprise
- Failure of the enterprise to file EIT returns

In case of failure of the withholding agent:

- A notification is issued within 15 days from the date of the failure
- The non-resident enterprise must fill the tax return

## DOUBLE TAX RELIEF

### ▪ **Foreign tax credit**

The general rule for tax credit is that an enterprise which derives income from outside China and which has paid foreign tax on this income, can deduct from the tax amount payable in China, the amount of foreign tax already paid.

#### Foreign tax eligible for credit

The foreign tax eligible for tax credit is the amount of income tax paid outside of China on income derived from China. The amount of foreign tax reduction and exemption is excluded from the tax credit unless otherwise stipulated by relevant double tax treaty.

#### Limit of foreign tax credit

The amount allowed for a tax credit is limited. It should notably not exceed the amount of China income tax. The limit of foreign tax credit is calculated according to the following formula:

$$\text{Foreign tax credit limit} = A \times B / C$$

A = Total Chinese income tax payable on China-sourced and foreign-sourced income

B = Amount of foreign-sourced taxable income

C = Total amount of China-sourced and foreign-sourced taxable income

▪ **Double taxation agreement between China and Italy**

China has concluded bilateral tax treaties with many countries, notably Italy, for the prevention of double taxation with respect to taxes on income or capital. The provisions of any double taxation agreements between China and a foreign government prevail in case of any inconsistency with the EITL.

Double taxation Agreement between China and Italy has been signed on 31 October 1986 and is effective since 1 January 1990. The main provisions of this agreement are simplified as follows:

<b>Treaty type</b>	<b>Tax on dividends</b>	<b>Tax on interest</b>	<b>Tax on royalties</b>	<b>Tax sparing relief</b>
On income	10%	10% with exemptions for certain limited situations	7% for royalties paid for the use or the right to use industrial, commercial or scientific equipment  10% for other cases	Available