Tax

The People's Republic of China Tax Facts and Figures

Foreword

This booklet has been prepared to provide the reader with an overview of taxes levied in the People's Republic of China. It is not intended to cover exhaustively the subjects it addresses but rather to answer some of the important, broad questions that may arise for the reader. When specific issues arise in practice, it will be necessary to refer to the laws, regulations and interpretations of the PRC. Since the laws and regulations are still evolving and are not always uniformly interpreted, it is advisable to obtain appropriate professional advice.

If you would like more information on any of our services described on pages 28 to 29, please contact one of our specialists listed at the back of this booklet.

The commentary in this booklet does not cover taxes levied in Hong Kong and Macao, which became Special Administrative Regions of the PRC on 1 July 1997 and 20 December 1999 respectively. Hong Kong and Macao continue to retain their own tax systems and the taxes applicable in Mainland China do not apply in Hong Kong and Macao.

The new Corporate Income Tax Law was released in March this year. However, the implementation details have not been finalised and released. An updated version of this booklet will be available shortly after the implementation details are published.

Contents

Tax administration

The tax administration of foreign investment enterprises ("FIEs") and foreign enterprises ("FEs"), including foreign representative offices, is handled by two separate tax bureaux. Generally, Foreign Enterprise Income Tax (which is imposed on all FIEs and FEs as well as certain activities of foreign representative offices) and Value Added Tax ("VAT") are collected by the local branches of the State Administration of Taxation whereas Business Tax ("BT"), Individual Income Tax ("IIT") and other local taxes are collected by the local tax bureaux.

Foreign Enterprise Income Tax ("FEIT") for Foreign Investment Enterprises and Foreign Enterprises (to be annulled on 1 January 2008)

China currently has two different enterprise income tax regimes, one (so-called FIET law) is applicable to FIEs and FEs and the other applicable to domestic enterprises. On 16 March 2007, China's top legislature passed the new corporate income tax law ("CIT") which consolidates the two separate enterprise income tax regimes into a single one. A highlight of the new CIT law which will come into effect on 1 January 2008 will be covered separately in the next section.

– General introduction

The taxation of corporate entities depends on whether the entity is a FIE or a FE.

FIEs include Chinese-foreign equity joint ventures, Chinese-foreign contractual joint ventures and wholly foreign-owned enterprises established in the PRC. FEs include foreign companies, enterprises and other economic organisations that are not Chinese legal entities, but have establishments or places in the PRC and are engaged in production or business operations. "Establishments or places" refers to management organisations (head offices), business organisations, representative offices and factories, places where natural resources are exploited, where contracted projects of construction, installation, assembly or exploration are carried out, or where labour services are provided, and also includes business agents.

FIEs are taxed on their worldwide income, with a tax credit for foreign taxes paid on foreign sourced income. FEs with establishments in the PRC are taxed on their PRC sourced income after deducting allowable costs, expenses and losses, or on a deemed profit basis (which is more common). FEs without establishments in the PRC should be taxed on their PRC sourced income at a statutory withholding rate of 20%. Starting from 1 January 2000, a concessionary rate of 10% has been applied to interest, rental, royalties and other income. In addition, the withholding tax rate may also be reduced by a tax treaty.

– Enterprise income tax

The standard FEIT rate applicable to both FIEs and FEs is 30%. However, this rate may be reduced either to encourage certain kinds of business activity or to encourage activities generally in a Special Economic Zone or other incentive areas. Alternatively or additionally, tax holidays may apply to certain types of activity which the State wishes to encourage. These concessions are discussed further below.

– Local income tax

Local income tax is levied on taxable income at the rate of 3%, giving a total standard income tax rate (foreign enterprise income tax and local income tax) of 33%. Exemption or reduction in local income tax may be granted to FIEs engaged in industries or projects encouraged by the State, if the local tax authorities so decide.

– Concessionary tax rates

The PRC provides a comprehensive program of tax incentives and concessions based primarily on such considerations as total investment, technical output, export potential, economic management and development, technology and general conduciveness to the PRC's economic activities.

Some incentives and concessions apply only to production enterprises whereas others apply also to non-production enterprises. Enterprises engaged in commerce, finance, insurance and service industries are generally considered to be non-production enterprises.

The open investment zones and the reduced FEIT rates can be summarised in the following main groups:

- Special Economic Zones ("SEZs")

Hainan, Shantou, Shenzhen, Xiamen and Zhuhai.

FIEs and FEs engaged in production or non-production business operations in these zones pay FEIT at 15%.

FIEs in a SEZ engaged in services and with foreign investment exceeding US$5 million and an operating life of more than ten years may be exempted from FEIT in the first profit-making year and permitted a 50% reduction in the following two years.

FIEs in the Hainan SEZ engaged in infrastructural or agricultural development projects with an operating life of more than 15 years are eligible for a five-year FEIT exemption starting from the first profit-making year and a 50% reduction in the following five years.

- Economic and Technological Development Zones ("ETDZs")

Beijing, Changchun, Changsha, Chengdu, Chongqing, Dalian, Dayawan, Dongshan, Fuqing-Rongqiao, Fuzhou, Guangzhou, Guiyang, Hangzhou, Harbin, Hefei, Hohhot, Kunming, Kunshan, Lanzhou, Lhasa, Lianyungang, Nanchang, Nanjing, Nanning, Nansha, Nantong, Ningbo, Qingdao, Qinhuangdao, Shanghai (Caohejing, Hongqiao, Minhang), Shenyang, Shihezi, Tianjin, Taiyuan, Urümqi, Weihai, Wenzhou, Wuhan, Wuhu, Xian, Xiaoshan, Xining, Yantai, Yinchuan, Yingkou, Zhanjiang and Zhengzhou.

Production FIEs in these zones pay FEIT at 15%.

- Old Urban Districts of SEZs and ETDZs and the Coastal Open Economic Zones

FIEs in these areas established with the approval of the State Council engaged in technology or knowledge-intensive projects, energy, transport and harbour or wharf construction projects or other projects with investment of more than US$30 million and a long repayment period may pay FEIT at 15%. Other production FIEs in these areas may pay FEIT at 24%.

- Hi-Tech Industry Development Zones ("HTIDZs")

Anshan, Baoding, Baoji, Baotou Xitu, Beijing Zhongguancun, Changchun, Changsha, Changzhou, Chengdu, Chongqing, Dalian, Daqing, Foshan, Fuzhou, Guangzhou, Guilin, Guiyang, Hainan Guoji, Hangzhou, Harbin, Hefei, Huizhou Zhongkai, Jilin, Jinan, Kunming, Lanzhou, Luoyang, Mianyang, Nanchang, Nanjing, Nanning, Qingdao, Shanghai, Shenyang, Shenzhen, Shijiazhuang, Suzhou, Taiyuan, Tianjin, Urümqi, Weifang, Weihai Huoju, Wuhan Donghu, Wuxi, Xiamen Huoju, Xian, Xiangfan, Yangling Nongye, Zhengzhou, Zhongshan Huoju, Zhuhai, Zhuzhou and Zibo.

FIEs located in HTIDZs which have been confirmed as high or new technology enterprises pay FEIT at 15%.

FIEs classified as Hi-Tech Enterprises ("HTEs") with an operating term of more than ten years and located in a HTIDZ may be eligible for a two-year FEIT exemption for the first and second profit-making years.

FIEs classified as HTEs and located in the HTIDZ of Beijing may be eligible for a three-year FEIT exemption starting from the establishment date and a 50% reduction in the next three years.

FIEs classified as HTEs and located in a SEZ or ETDZ are eligible for the tax preferential treatment offered to FIEs in the SEZs or ETDZs.

- Bonded Zones

Dalian, Fuzhou, Guangzhou, Haikou, Ningbo, Qingdao, Shanghai (Waigaoqiao), Shantou, Shenzhen (Futian, Shatoujiao and Yantian Harbour), Tianjin Harbour, Xiamen (Xiangyu), Zhangjiagang and Zhuhai.

FIEs engaged in processing and assembly for export in approved bonded areas pay FEIT at 15%.

- Export Processing Zones

Beihai, Beijing (Tianzhu), Changshu, Changzhou, Chenzhou, Chengdu, Chongqing, Cixi, Dalian, Fuzhou, Fuqing, Guangzhou, Hangzhou, Hohhot, Huichun, Huizhou, Jinan, Jiaxing, Jiujiang, Kunming, Kunshan, Langfang, Lianyungang, Mianyang, Nanjing, Nansha, Nantong, Ningbo, Qinhuangdao, Qingdao, Quanzhou, Shanghai (Caohejing, Jiading, Jinqiao, Minhang, Qingpu, Songjiang), Shenyang, Shenyang (Zhangshi), Shenzhen, Suzhou, Suzhou new district, Tianjin, Ürümqi, Weihai, Weifang, Wuhan, Wuhu, Wujiang, Wuxi, Wuzhong, Xian, Xiamen, Yantai, Yangzhou, Zhenjiang and Zhengzhou.

FIEs engaged in processing and assembly for export may enjoy tax treatments applicable in ETDZs.

- **Shanghai Pudong New Area**

Production FIEs and FIEs engaged in energy or transport construction projects in this area pay FEIT at 15%.

FIEs located in the Shanghai Pudong New Area with an operating life of more than 15 years engaged in energy or transport construction projects are eligible for a five-year FEIT exemption starting from the first profit-making year and a 50% reduction in the following five years.

- **National Tourism Areas**

FIEs in National Tourism Areas designated by the State Council may pay FEIT at 24%.

- **Other areas**

Preferential rates may be available in the Suzhou Industrial Park and Taiwanese Investment Districts.

In addition, other tax holiday incentives that provide complete or partial exemption from FEIT are outlined below:

- **Production**

Production FIEs are eligible for two years of exemption from FEIT starting with the first profit-making year and a 50% reduction in FEIT during the subsequent three years if their operating term is more than ten years.

Enterprises engaged in exploiting natural resources such as oil, natural gas and rare or precious metals do not qualify for these concessions.

- **Oil, natural gas, rare metals and precious metals**

Exemption from or reduction in FEIT for these activities is regulated separately by the State Council.

- **Agriculture, forestry and animal husbandry**

FIEs engaged in these activities in remote under-developed areas with an operating term of more than ten years may apply for a 15% to 30% reduction in FEIT for an additional ten years following the expiration of the two-year full exemption and three-year 50% reduction in FEIT.

• Technologically advanced and export-oriented enterprises

FIEs classified as technologically advanced enterprises may apply for a three-year extension of the 50% FEIT reduction, subject to a minimum reduced tax rate of 10%.

On the expiry of the ordinary tax holiday, FIEs exporting 70% or more of their output in a given year are eligible for a 50% reduction in FEIT in that year, with proper documents filed to the tax authority, subject to a minimum reduced tax rate of 10%.

• Harbour and wharf construction

Chinese-foreign joint ventures engaged in harbour or wharf construction may pay FEIT at 15%. Alternatively, if their operating term is not less than 15 years, they may apply for a five-year FEIT exemption starting from the first profit-making year and a 50% reduction in the following five years.

• Financial institutions

Financial institutions with foreign investment exceeding US$10 million with an operating life of more than ten years located in SEZs or other districts approved by the State Council may pay FEIT at 15% on their foreign currency business. Such financial institutions may be eligible for a one-year FEIT exemption, starting from the first profit-making year, and a 50% reduction in the next two years. These reduced tax rates do not apply to RMB currency trading which will be subject to FEIT at 30% plus local income tax at 3%.

• Representative offices

Permanent representative offices engaged in conducting market surveys, collecting business information and liaison or other preparatory and supplementary services provided in relation to the production and sales of products manufactured by their head office may be exempt from business tax and FEIT. All other activities including trading, merchandising, servicing, investing, consulting and other agency activities are subject to FEIT and business tax. Liaison services to affiliates within a group are also treated as taxable activities.

– Tax refund on reinvestment

A foreign investor in a FIE that directly reinvests its share of profit in the PRC either in that FIE or in another FIE with an operating period of more than five years may obtain a tax refund of 40% of the FEIT paid on the amount reinvested. If the reinvestment is made in establishing or expanding an export-oriented enterprise or a technologically advanced enterprise in the PRC, the tax refund is increased from 40% to 100%.

A foreign investor in a FIE established in Hainan province that reinvests its share of profit in Hainan's construction of infrastructural facilities or agricultural development may obtain a refund of 100% of the FEIT paid on the reinvested profit.

– Investment restrictions on foreign investors

In the promotion of foreign investment, the PRC government puts major emphasis on production enterprises, i.e. capital-intensive and technology-intensive manufacturing industries, and those for the development of infrastructure facilities.

Foreign companies, enterprises or individuals may, subject to approval from the Ministry of Commerce or other relevant ministries, establish equity joint ventures, contractual joint ventures or wholly foreign-owned enterprises in the PRC. For joint ventures, to enjoy various tax incentives, the proportion of investment contributed by the foreign participants should not be less than 25%.

The minimum registered capital of a FIE is as follows:

Amount of Total Investment	Minimum Registered Capital
US$3 million or less	70% of total investment
US$3-10 million	Higher of US$2.1 million or 50% of total investment
US$10-30 million	Higher of US$5 million or 40% of total investment
More than US$30 million	Higher of US$12 million or 33.3% of total investment

FIEs are encouraged, restricted or prohibited in their investments in the PRC in the following areas:

Encouraged: certain agriculture, forestry, animal husbandry and fisheries, mining, manufacturing; electricity, gas and water production and supply, water conservancy, communications, transportation, warehousing, postal and telecommunications services, certain wholesale and retail trade, real estate industry for ordinary apartments, social services, sanitation, fitness and social welfare industries, education, culture, art, radio, film and television industries, scientific research and comprehensive technical services, and foreign-funded projects in permitted categories that directly export all of their products;

Restricted: certain agriculture, forestry, animal husbandry and fisheries (e.g. production of grains, cotton, processing of precious varieties of trees); mining of precious metal and certain ores, certain manufacturing (e.g. good processing, tobacco processing, textile, etc.), electricity (i.e. adoption of low capacity generator), certain communications, transportation, warehousing, postal and telecommunications services, wholesale and retail of certain products, banking and insurance industries, real estate industry in high end property market, public utilities, medical institutions, golf courses, senior high school, production and distribution of radio, TV programme, surveying, certification and appraisal, and other industries that are restricted by the State or by international treaties concluded or acceded to by the PRC;

Prohibited: certain agriculture, forestry, animal husbandry and fisheries (e.g. breeding and growing of precious, high-quality breeds, production and development of transgenic plant seeds, etc.); mining of radioactive minerals and rare earth, certain manufacturing (e.g. medicine manufacturing, arms and ammunition manufacturing, etc.), construction and operation of power grids, air traffic control, postal service, future trading, social research, gambling industry, pornography, publication of books, newspaper, production and importation of audio-visual products and other industries that are prohibited by the State or by international treaties concluded or acceded to by the PRC.

– Special deductions and other matters

• Depreciation

Wear and tear allowances are granted on fixed assets and other capital assets used in the production of income. Generally the straight-line method of depreciation is allowed and other depreciation methods can be adopted if it is reasonable and the required documentation is filed to the tax authorities.

In computing the depreciation on fixed assets, the residual value (which generally cannot be less than 10% of the original value) is assessed and deducted from the original value. Depreciation on fixed assets is computed beginning with the month following that in which the assets are put into use and ceasing with the month following that in which the fixed assets are no longer used.

Minimum depreciation periods for different kinds of fixed assets are specified as follows:

Premises, buildings and structures	20 years
Train, ships, machinery and other production equipment	10 years
Electronic equipment, means of transport other than trains and ships, appliances, tools, furniture, etc.	5 years

In special circumstances, approval may be given for accelerated depreciation rates where machinery is subject to abnormal conditions or usage.

• Intangibles

Intangible assets are amortised by the straight-line method over a period of not less than ten years or the stipulated time limit set out in the contract or agreement under which use of the intangible asset is made available.

• Pre-operating expenses

Pre-operating expenses include expenses (other than expenses on specific fixed assets and intangibles) incurred from the date of approval of setting up an enterprise to the date of commencement of (trial) production or business operations.

Pre-operating expenses are amortised over a period of not less than five years unless the enterprise has an operational life of less than five years.

• Management fees

Special rules apply to limit deductions for management fees and other recharges by an overseas head office or related entity.

Management fees as such are generally not deductible. However, if certain conditions are met, deductions may be allowed for administrative fees and other expense recharges.

• Interest on loans

Interest on loans will generally be deductible where the interest rate is a commercial one and the documentation of the loan and interest paid have been filed with the tax authorities.

Interest incurred during preliminary or construction phases of operations and interest on loans to purchase fixed assets may be required to be capitalised and depreciated or amortised.

• Entertainment

Entertainment expenses relating to the production and business operations of a FIE must be substantiated by reliable records and vouchers and are deductible within the following limits:

- where annual net sales are RMB15 million or less, the deduction shall not exceed 0.5% of net sales; for the portion above RMB15 million, the deduction shall not exceed 0.3%; or
- where annual total business income is RMB5 million or less, the deduction shall not exceed 1% of total business income; for the portion above RMB5 million, the deduction shall not exceed 0.5%.

The limitations applied to annual net sales should be used by industrial, manufacturing and similar enterprises whereas the limitations applied to total business income should be used by finance, insurance, transportation and other service enterprises.

• Foreign social insurance premiums

Foreign social insurance premiums paid for employees working inside the PRC are specifically not deductible.

• Bad debts

Enterprises engaged in the credit and leasing business may, with filing of proper documentation with the local tax authorities, provide annually for doubtful debts up to amounts not exceeding 3% of the year-end balances of their loans (not including interbank loans) or of their accounts receivable, bills receivable and other receivables and may deduct the provision from taxable income of that year.

Bad debts incurred by an enterprise that exceed the bad debt provision for the preceding years can be deducted as a loss in the current year. If the bad debts incurred are less than the bad debt provision for the preceding years, the difference is taken into the taxable income for the current year.

Accounts receivable can be written off as bad only if the debtor:

- is bankrupt;
- dies; or
- has failed to repay the debt for over two years.

If part of a bad debt is recovered in a subsequent year, it should be included in the taxable income for that year.

• Inventory valuation

Inventory of commodities, finished products, work-in-progress, semi-finished goods and raw materials of a FIE must be valued according to cost prices. In computing actual cost prices for delivery and acceptance of inventory, the FIE may choose one of the following methods: first-in first-out, moving average, weighted average or last-in first-out.

• Loss carryovers

Net losses incurred by enterprises engaged in production or business operations generally may be carried forward for a period up to five years.

• Treatment of dividends

Dividends received by FIEs in the PRC are not taxable whereas the relevant investment expenses are not deductible. Withholding tax may apply to certain dividends received by FEs without establishments in the PRC. However, dividends received by FEs from a FIE is exempt from withholding tax.

• Related party transactions

All FIEs and FEs are required to conduct revenue and capital transactions with related parties on an arm's-length basis. The tax authorities pay special attention to transfer pricing practices and have broad powers to disregard, vary or make adjustments to related party transactions that reduce taxable income of an enterprise.

In defined circumstances involving an internal corporate reorganisation, assets and investments may be transferred at "book values" without giving rise to gains.

• Consolidated tax filing

A FIE having two or more business establishments in the PRC has to perform tax filing on a consolidated basis. A FE having two or more establishments in the PRC may select one establishment for consolidated tax filing and payment. That establishment must meet the following requirements:

- it assumes supervisory and management responsibility over the business of the other establishment(s); and
- it keeps complete accounting records and vouchers that correctly reflect the income, costs, expenses, profits and losses of the other establishment(s).

The FEIT paid with the consolidated tax filing will take into account the FEIT rates and tax holidays applying to each separate business establishment.

FIEs cannot file consolidated returns on a group basis.

• Tax period

The normal tax year is the calendar year. In exceptional cases, a FE may use its own 12-month fiscal year as the tax year with specific tax authority approval.

- Currency

Income tax is computed in Renminbi (RMB) currency. Income in foreign currency is converted into RMB at exchange rates quoted by the State exchange control authorities for tax payment purposes.

Exchange gains or losses are generally taxable or deductible when realised.

- Deemed taxable income

If a FIE or FE cannot submit complete and accurate documentation of its costs and expenses to enable its taxable income to be calculated, the tax authorities may assess a taxable income by applying a deemed profit percentage to its gross income or turnover. This deemed profit percentage will vary depending on the industry in which the FIE operates and will usually be between 10% and 40%.

– Tax filing and payment

FEIT is levied on an annual basis and is paid in four quarterly estimated installments. Provisional payments are due 15 days after the end of each quarter and a final settlement is due within five months after the end of a year.

– Withholding tax on payments to non-residents

Starting from 1 January 2000, a concessionary rate of 10% has generally been applied to interest, rental, royalties and other income. In addition, the withholding tax rate may also be reduced by a tax treaty.

- Dividends and profit repatriation by FIEs

Dividends paid or profits distributed by a FIE to foreign investors are exempt from withholding tax.

- Interest income

PRC-sourced interest received by FEs will generally be subject to withholding tax. However, certain interest income may be exempt from withholding tax or may be eligible for a reduced withholding tax rate under a tax treaty or by concession.

- Leasing income

Payments to a non-resident lessor which does not have an establishment or site in the PRC under either a finance lease or an operating lease will generally be subject to withholding tax. However, certain lease receipts may be exempt from withholding tax or may be eligible for a reduced withholding tax rate.

- Royalties

Royalty payments to a non-resident from patent, trademark, copyright and other similar rights will generally be subject to withholding tax at the rate of 10%. That rate may be reduced through the operation of a tax treaty or by concession. Certain royalty payments may be exempt from withholding tax.

- Other income

Gains from the sale or transfer of housing, buildings and land use rights are subject to withholding tax at 10%.

Gains on the sale or transfer of an investment in the PRC by a FE are also subject to withholding tax.

Corporate Income Tax ("CIT") Law (to be effective on 1 January 2008)

The new CIT regime earmarks the consolidation of two separate enterprise income tax regimes for domestic-invested enterprises, FIEs and FEs into a single regime. In addition, the new CIT Law provides for a fundamental change in China's tax incentive policy in shaping and directing the future development of the country. As it mainly provides a framework of general tax provisions, important details on the definition of numerous terms as well as the interpretation and specific application of various provisions are left to the detailed implementing regulations and supplementary tax circulars to be formulated by the State Council at a later stage.

Set forth is a brief summary of the major aspects of the new CIT Law

– Concept of "Tax Resident Enterprise" ("TRE")

TRE concept is introduced whereby TREs are subject to China income tax on worldwide income, and non-TREs on China sourced income. Enterprises registered in China are always TRE. A FE with effective management institute based in China is regarded as a “TRE”. This new concept goes beyond the current “Permanent Establishment” concept which taxes FEs only on their China sourced income.

– Tax rate for FIEs

The new CIT rate is 25%. A lower tax rate is available for qualified small and thin-profit companies (20%) and for qualified high/new technological enterprises (15%) without geographical limitation.

– Tax rate for FEs

WHT rate for passive income derived by Non-TREs is 20%. The new CIT Law does not specifically exempt WHT on dividend payable to foreign investors. It does not specify if the concessionary WHT rate (10%) currently applicable to interest, rental, royalty, and other passive income would survive. Nevertheless, it provides for the possibility of WHT exemption or reduction for China sourced income, the details of which is expected to be addressed in the implementation rules at a later stage.

– Tax incentive policies

The new regime adopts the “Predominantly Industry-oriented, Limited Geography-based” tax incentive policy, which is a significant difference from the existing regime which is “Geography-based”. Key emphasis is placed on “industry-oriented” incentives aiming at directing investments into those industry sectors and projects encouraged and supported by the State. The new tax incentive policies mainly include:

• Tax reduction and exemption

Tax reduction and exemption treatments are targeted primarily towards (i) agriculture, forestry and animal-husbandry, fishery projects, (ii) basic infrastructure projects; (iii) environment protection projects and energy/water conservative projects; (iv) qualified technology transfer.

• Super deduction

“Super deduction” is allowed for R&D expenses for new technology, new products, new craftsmanship.

- Reduction of taxable income

Taxable income may be reduced by a deemed deduction calculated as a percentage of investment amounts for venture capital businesses engaged in encouraged industries.

- Accelerated depreciation

Shorter tax depreciation life or accelerated depreciation is allowed for particular types of fixed assets due to advancement of technology.

- Reduction of revenue

Reduction allowance may be allowed for revenue earned from products manufactured with comprehensive resources pursuant to the State industry policies.

- Investment tax credit

Investment tax credit is allowed on qualifying expenditures on plant and machinery for environmental protection, energy and water conservation, and production safety.

– Grandfathering of previous preferential tax treatments

In order to provide transitional relief to the adversely affected taxpayers due to the increase of tax rates and cancellation of tax holiday benefits provided under the current FEIT regime for FIEs and FEs, existing FIEs will still be able to enjoy, to a certain extent, reduced tax rate and tax holiday treatments in accordance with the current FEIT Law. The grandfathering provisions include:

- Reduced tax rate

FIEs approved before the publication date of the new CIT Law and currently taxed at a rate lower than 25% will be offered a gradual increase of tax rate to 25% within 5 years.

- Tax holiday

Unused tax holiday of FIEs approved to be established before the publication of the new CIT Law is grandfathered till the expiry. Where the tax holiday has not yet started because of tax losses, it shall be deemed to commence from 1 January 2008.

- High/new tech industries in SEZs and Shanghai Pudong New Area

New FIEs which engage in high/new-tech industries encouraged by the State and located in SEZs and Shanghai Pudong New Area may enjoy transitional preferential treatments (The details should be unveiled at a later stage).

- Western Region

Enterprises in encouraged industries located in Western regions would continue to enjoy the existing tax incentives .

– Tax deductions

The new CIT Law only provides a framework and general guidelines regarding tax deduction. The details of tax deduction will be provided in the detailed implementation rules to be issued later in 2007.

– Anti-avoidance Rules

- Cost sharing

Cost sharing is allowed in respect of intangible assets developed and shared among related parties, and for the provision and receiving of common services, as long as the sharing basis is on arm's length.

- Documentation of related party transactions

More stringent requirements on filing and submission of related party information for transfer pricing enforcement will be adopted.

- Controlled foreign company rules (“CFC Rules”)

CFC rules are introduced such that undistributed profits derived by CFCs located in certain low-tax jurisdictions may be taxed in China as a deemed distribution.

- Thin capitalisation rule

Thin-capitalisation rule is introduced such that excessive interest expense arising from related party loans may be disallowed.

• General anti-avoidance provision

There is a general anti-avoidance provision for making adjustments to taxable revenue or taxable income where business transactions are regarded as arranged without reasonable commercial purpose.

• Interest levy on tax adjustments

Tax adjustments made by tax authorities under the anti-avoidance chapter may be subject to interest levy.

– Tax filing and payment

Filing of annual tax return period is extended to 5 months after year end. Provisional reporting and payments may be made on a monthly basis or quarterly basis.

Individuals

– Tax liability

Foreign individuals residing in the PRC for less than one year are subject to tax only on PRC sourced income. Remuneration from foreign employers to individuals working in the PRC is exempt from tax if the individual resides in the PRC for less than 90 days in a calendar year, provided the remuneration is not borne by an establishment in the PRC. This 90-day period may be extended to 183 days if the individual is entitled to protection under a tax treaty/tax arrangement.

Employees of foreign employers can reduce their IIT liability to reflect the actual number of days residing in the PRC if certain criteria are met.

Individuals who are not domiciled in the PRC but reside in the PRC between one to five years may, with approval, pay tax only on their PRC sourced income and non-PRC sourced income, payment of which is borne by PRC establishments. Commencing in the sixth year, their worldwide income will be taxed.

– Personal income tax rates

Income from wages and salaries is taxed according to the following progressive rates, ranging from 5% to 45%:

Monthly taxable income*		Tax on lower amount	Percentage on excess %
Over	Not over		
RMB 0	RMB 500	RMB 0	5
500	2,000	25	10
2,000	5,000	175	15
5,000	20,000	625	20
20,000	40,000	3,625	25
40,000	60,000	8,625	30
60,000	80,000	14,625	35
80,000	100,000	21,625	40
100,000		29,625	45

*Monthly taxable income is calculated after a standard monthly deduction of RMB4,800 for individuals not domiciled in the PRC. For individuals domiciled in the PRC, the standard monthly deduction is RMB1,600.

If the individual income tax is borne by the employer, a different tax rate table will be used to reflect the tax-on-tax effect.

– Employment benefits

For IIT purposes, taxable income refers to “wages, salaries, bonuses, labour services fee, dividends, allowances or subsidies or other income related to job or employment”.

Certain employment benefits are specifically treated as not being taxable under the IIT law. These include:

- employee housing costs (with supporting invoices) borne by an employer;
- reasonable home leave fares of 2 trips per annum of the employee (with supporting invoices);
- reasonable employee relocation and moving costs (with supporting invoices); and
- reasonable reimbursement of certain meals, laundry, language training costs and children’s education expenses in the PRC (with supporting invoices).

An allowance paid to cover expected work-related expenditures (such as an entertaining or travel allowance) will be fully taxable to an employee. IIT may be reduced by reimbursing specific expenses incurred by an employee (which may include entertainment, health or social club fees, local travel, newspapers and journals, telephone costs, etc.) instead of paying an allowance. The expense reimbursement may not be subject to IIT if prescribed administrative procedures are followed.

– Income other than employment income

• Proprietors; contracting and leasing

Operating profit of individual industrialists and merchants from production and business operations or from contracting or leasing operations is subject to tax at progressive rates ranging from 5% to 35%. The 35% marginal rate applies to annual taxable income (gross revenue less allowable costs, expenses and losses) over RMB50,000.

• Income of authors

Such income is taxed at a flat rate of 20%, applied to 70% of gross authorship income.

• Compensation for personal services

Such income is taxable at 20% if the taxable income (after allowable deductions) from a single payment does not exceed RMB20,000; 30% for the portion over RMB20,000 but not exceeding RMB50,000; and 40% for the portion exceeding RMB50,000.

• Royalties, interest, dividends, bonuses, leases on or assignment of property, other income

Such income is taxed at a flat rate of 20%.

• Allowable deductions

On income from contracting and leasing operations, a monthly deduction of requisite expenses of RMB1,600 is allowed. On income from compensation for personal services, royalties, or leases on property, a deduction of RMB800 is allowed if the income received in a single payment is less than RMB4,000. If the income received in a single payment is more than RMB4,000, a 20% deduction is allowed. No deduction is allowed against income from interest, dividends, bonuses or other income. For transfers of property, the original cost plus reasonable expenses are deductible.

– Tax filing and payment

IIT is normally withheld from wages or salaries by employers and paid over to the tax authorities on a monthly basis. An expatriate employee whose payroll is borne by a PRC employer is also subject to IIT monthly. Individual income tax returns must be filed within seven days following the end of each month.

– Annual IIT self reporting requirement

Starting from 1 January 2007, individuals under four circumstances are required to perform annual self IIT reporting with the PRC tax authorities. Foreign individuals may be exempted from this obligation in certain situations.

Other taxes

– Value added tax ("VAT")

FIEs, FEs and domestic enterprises pay either VAT or business tax depending on the nature of their business and the type of products involved. VAT applies to enterprises engaged in importation, production, distribution or retailing activities.

The general VAT rate is 17% but necessities, such as agricultural and utility items, are taxed at 13%. Certain limited categories of goods are exempt from VAT.

Enterprises regarded as small businesses (annual production sales of less than RMB1 million or annual wholesale or retail sales of less than RMB1.8 million) are subject to VAT at the rate of 4% or 6%. Unlike other VAT payers, small businesses are not entitled to claim input tax credits for the VAT paid on their purchases.

Export of goods from China may be entitled to a refund of VAT incurred on the purchases of domestic materials. As the refund rates ranges from 0% to 17% and under the prescribed formula for determining the amount of refund, many products do not enjoy the full refund of input VAT credit and suffer a different degree of export VAT costs.

– Customs duties

Customs duties are generally imposed on goods imported into or exported out of the PRC at various rates. Given China's accession to the WTO, the import duty rates drop significantly since 1 January 2002. For certain categories of goods, a zero rate may apply. Meanwhile, VAT and, if applicable, consumption tax are also imposed on the importation of certain goods.

Customs duties on imports are based on either general rates or preferential rates, depending on whether the PRC has reciprocal tariff agreements with the exporting country.

Customs duty and VAT are exempt on machinery and equipment imported by a FIE within the amount of its total investment, for its own use if the project involves a technology transfer and falls within the encouraged category of the new "Catalogue Guiding Foreign Investors on Industries for Investment", and the imported machinery or equipment is not within the 20 items listed in the "Catalogue of Non-exempt Commodities Imported for Foreign-invested Projects."

Limited exemptions from customs duty may also apply to machinery and equipment and other goods which are temporarily imported into the PRC, provided they are re-exported. The temporary importation period is generally six months, although this period may be extended to one year. A deposit for the duty may be required.

Customs duty and VAT exemption may be allowed on importation of raw materials for contract processing or import manufacturing.

Customs duty and VAT exemption may also be available, in special circumstances, for imported machinery and equipment and related goods used in import manufacturing activities in certain circumstances.

Goods may be imported into, and exported out of, designated Free Trade Zones such as the Waigaoqiao Free Trade Zone in the Pudong New Area, Shanghai, without liability to customs duty or VAT.

– Business tax

FIEs, FEs and domestic enterprises may be liable to business tax instead of VAT, depending on the business or assets involved. Business tax is imposed in relation to transactions within the PRC on services provided by enterprises engaged in the transportation, construction, post and telecommunications, finance and insurance and other service industries, as well as on the transfer of immovable properties and intangible assets.

Business tax is levied on gross turnover at rates between 3% and 20%. The most common rates are either 3% or 5%. Limited exemptions from business tax may apply to some services.

– Consumption tax

Consumption tax is levied on manufacturers and importers of specified categories of consumer goods, including tobacco, alcoholic beverages, ethyl alcohol, cosmetics, luxury skin care products, jewellery, fireworks, gasoline and diesel and certain petroleum products, automobile tyres, motorcycles, automobiles, golf equipment, yacht, luxury watch, disposable chopsticks and wooden floorboard. The rates range from 3% to 45%. Consumption tax is imposed in addition to applicable customs duties and VAT.

– Land appreciation tax ("LAT")

LAT is levied on certain gains realised from real property transactions at progressive rates from 30% to 60%, based on the "land value appreciation amount" which is the consideration received from the transfer or disposition of real property less the "total deductible amount".

The "total deductible amount" includes:

- the amount spent on obtaining the land use right;
- costs and expenses of land development;
- costs and expenses of the construction of new buildings and supplementary facilities;
- taxes in connection with the transfer of real property (generally business tax and stamp tax); and
- other deductions as determined by the Ministry of Finance.

For taxpayers engaged in a real estate development business, an additional deduction equal to 20% of the sum of the first three cost items noted above is allowed.

Finance expenses, such as interest, may be deducted in certain circumstances. Other real property development expenses (i.e. selling and administrative) are limited to 5% of the total amount expended to acquire the land use right and the costs of land development and construction.

– Stamp tax

All enterprises and individuals who execute or receive "specified documentation" are subject to stamp tax. Rates vary between 0.005% on loan contracts to 0.1% for property leasing and property insurance contracts. A flat amount of RMB5 applies to certification evidencing business licences and patent, trademark or similar rights.

– Urban real estate tax

Urban real estate tax is a tax imposed on the owners, users or custodians of houses and buildings. The tax rate is 1.2% of the original value of buildings. A tax reduction of 10% to 30% is commonly offered by local governments. Alternatively, tax may be assessed at 12% of the rental value.

– Motor vehicle acquisition tax

Motor vehicle acquisition tax at a rate of 10% of the taxable consideration will be levied on any purchase and importation of cars, motorcycles, trams, electric buses, cart and certain types of trucks.

– Deed tax

Deed tax, generally at rates from 3% to 5%, may be levied on the purchase or sale, gift or exchange of ownership of land use rights or real properties. The transferee/assignee is the taxpayer.

– Vehicle and vessel tax

A tax that is levied on all vehicles and vessels used within the PRC. A fixed amount is levied on either a yearly or quarterly basis. Transport vehicles are generally taxed on a fixed amount according to own weight, with passenger cars, buses and motorcycles being taxed on a fixed unit amount. Vessels are taxed on a fixed amount according to deadweight tonnage.

– Urban and township land-use tax

From 1 January 2007, the State expanded the scope of urban and township land-use tax to include FIEs. This tax is levied on taxpayers who utilize land within the area of city, country, township and mining districts. It is computed, on an annual basis, based on the space of area actually occupied by a taxpayer multiplied by a fixed amount per square meter that is determined by the local governments.

– Resource tax

Resource tax may be levied, generally on a tonnage or volume basis, at rates specified by the Ministry of Finance in consultation with relevant ministries of the State Council on natural resources including crude oil, natural gas, coal, other raw non-metallic metals, raw ferrous metals, non-ferrous metallic minerals and salt (including solid and liquid salt).

In lieu of resource tax, Mine Area Usage Fees are collected from joint ventures exploiting crude oil or natural gas.

Capital gains tax

There is no capital gains tax as such in the PRC. Gains on the sale of fixed assets are taxable as ordinary income. The transfer of immovable properties and intangible assets may also give rise to a business tax liability. LAT may also be payable in respect of certain gains realised from real property transactions.

Tax treaties/arrangements

Foreign tax relief and exemption or reduction in PRC tax may be afforded under a tax treaty (or arrangement) to which the PRC is a party. Tax treaties exist with the following countries or jurisdictions: Tax treaties may operate to reduce the amount of withholding tax or FEIT/CIT payable in the PRC by a FE or a foreign individual. A tax treaty may also operate to reduce the amount of overseas withholding or income tax payable by a resident of the PRC.

Albania
Armenia
Australia
Austria
Azerbaijan
Bahrain
Bangladesh
Barbados
Macao SAR
Macedonia
Malaysia
Malta
Mauritius
Mexico
Moldova
Mongolia

Belarus
Belgium
Brazil
Bulgaria
Canada
Croatia
Cuba
Cyprus
Czech Republic
Denmark
Egypt
Estonia
Finland
France
Georgia
Germany
HKSAR
Hungary
Iceland
India
Indonesia
Iran
Ireland
Israel
Italy
Jamaica
Japan
Kazakstan
Korea, Rep. of
Kuwait
Kyrgizastan
Laos
Latvia
Lithuania
Luxembourg
Morocco
Netherlands
New Zealand
Norway
Oman
Pakistan
Papua New Guinea
Philippines
Poland
Portugal
Romania
Russia
Seychelles
Singapore
Slovak Republic
Slovenia
South Africa
Spain
Sri Lanka
Sudan
Sweden
Switzerland
Thailand
Trinidad and Tobago
Tunisia
Turkey
Ukraine
United Arab Emirates
United Kingdom
United States
Uzbekistan
Venezuela
Vietnam
Yugoslavia

Foreign tax relief

A FIE may deduct from the amount of PRC tax payable the foreign income tax already paid overseas in respect of income derived from sources outside the PRC. However, the deductible amount may not exceed the amount of income tax otherwise payable in the PRC in respect of the income derived from sources outside the PRC.

Exchange controls

Foreign exchange transactions are controlled by the State Administration of Foreign Exchange ("SAFE") and its branches.

The regulatory control on foreign exchange transactions by a FIE depends on whether the transaction is a current account item or a capital account item. Under the PRC Foreign Exchange Control Regulations, current account items refer to ordinary transactions within the context of international receipts and payments, including balance of payments from trade, labour services, unilateral transfers, etc. Capital account items refer to items of increase or decrease in debt and equity due to inflow or outflow of capital within the context of international receipts and payments, including direct investment, all forms of loans, investment in securities, etc.

If a transaction falls under the category of current account items, in general, a FIE can purchase and sell foreign currency through designated banks on the interbank foreign exchange trading system without prior approval of the SAFE. When a FIE has to make a payment in foreign currency, it can instruct its bank to pay from its foreign exchange account. In the meantime, it should provide supporting documents such as contracts, invoices and shipping documents to the bank. When a FIE receives payment in foreign currency from exports, it should sell its foreign currency to authorised banks and may only retain foreign currency up to a certain pre-approved limit.

If a transaction falls under the category of capital account items, generally prior approval from the SAFE should be obtained.

The major features of exchange controls in the PRC concerning FIEs and FEs are as follows:

- a foreign exchange borrowing by a FIE is required to be registered with the SAFE;
- export proceeds of a FIE or receipts from sources outside the PRC are required to be transferred into the PRC;
- foreign personnel of a FIE may remit their after-tax salaries and other legitimate income abroad; and
- FIEs may, with the approval of the SAFE, open a foreign exchange account with a bank abroad.

PricewaterhouseCoopers' Services and Solutions in China

PricewaterhouseCoopers offers a wide range of tax and regulatory solutions to companies with operations in the PRC. These include:

- ❑ Corporate Restructuring
  Advise on share transfers, transfers of businesses, reorganisations of the capital and assets of enterprises, and liquidations.
- ❑ Corporate Tax Compliance and Planning
  Preparation and submission of corporate income tax and turnover tax returns. Negotiations with the tax authorities on corporate tax compliance issues, advice on tax planning opportunities.
- ❑ Customs & Trade Solutions
  Assist in identifying import and export savings opportunities and compliance needs.
- ❑ Distribution Strategies
  Advise on strategies to optimise the opportunities in China's distribution market within the latest legal framework.
- ❑ Establishment of Representative Offices and PRC Wholly Foreign-Owned Enterprises
  Setting up representative offices and PRC entites, obtaining business licenses and tax registrations, confirming for appropriate tax reporting methods, tax compliance, etc.
- ❑ Foreign Contractors
  Tax effective structuring for foreign contractors involving in China power plant and infrastructure projects, contract reviews, registrations, tax bureau negotiations, compliance requirements.
- ❑ Handling Tax Audits
  Assisting in preparing for a tax audit, handling queries from the tax authorities and negotiating tax settlements, etc.
- ❑ Health Check of PRC Operations
  Diognosing compliance of PRC operations with relevant rules and regulations, corrective actions, tax planning opportunities.
- ❑ Indirect Tax Planning
  Assist in actively manage indirect tax processes and explore indirect tax saving opportunities.
- ❑ Market Entry Advice
  Assist in developing entry strategies and setting up entities and offices within China.

- Mergers and Acquisitions – Due Diligence Reviews
  Perform a full-scope due diligence review or a specific – procedures review of regulatory risks and tax exposures.
- PRC Individual Income Tax Planning and Compliance
  Helping companies with foreign employees working in China to devise tax-effective compensation package, register their employees with the tax authorities, and prepare their monthly individual tax filings. Develop tax equalisation programs for China assignees.
- Structuring of Investment and Financing
  Advise on appropriate ownership structures and financing methods to minimise taxes and maximise returns.
- Transfer Pricing
  Perform a risk assessment review of transfer pricing policies and related exposures, reporting requirements, documentation of policies, tax planning, obtaining Advance Pricing Agreements, etc.

PricewaterhouseCoopers Contacts in China

PricewaterhouseCoopers has around 8,000 partners and staff in 12 offices in Mainland China, Hong Kong and Macao. The China Tax Services group has more than 800 client service professionals – including more than 50 China tax partners and directors – committed to surpassing client expectations.

PricewaterhouseCoopers has been consistently ranked the best brand in international tax services in Asia in the independent survey conducted by the International Tax Review.

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