CORPORATE INCOME TAX LAW AND PRACTICE IN THE PEOPLE'S REPUBLIC OF CHINA

FULI CAO

OXFORD

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Preface

THE OBJECTIVE OF this book is to provide a comprehensive guide to China Corporate Income Tax Law, to help business people, professionals, and students to better understand the China Corporate Income Tax system. A new Corporate Income Tax Law came into effect on January 1, 2008. The new tax law has unified the two former corporate income tax systems, one of which was applicable to domestic enterprises and one of which was applicable to foreign enterprises and foreign invested enterprises. The new tax law applies to all enterprises. Since the promulgation of the tax law and its implementation rules, the Ministry of Finance and the State Administration of Taxation have issued various interpretation circulars. A large portion of this book summarizes those circulars along with relevant sections of law. Lawyers, accountants, and other professionals may find the mapping of sections of tax law, regulations, and circulars and the areas of business transactions and operations useful. Detailed citations will allow readers to find the authorities at their original sources. I have also included some introductory and historical information for those who seek general knowledge of China tax law. Readers who are interested in narrowly-focused issues may choose to read selectively.

A chapter is devoted to addressing major areas of tax treaties and arrangements between China and other countries or regions. Tables summarizing treaty treatments such as permanent establishment, dividends, interest, royalties, and capital gain can provide readers with easy reference and comparison. Whilst the issues of administration and enforcement of specific tax rules are discussed in various chapters, separate chapters cover tax compliance and tax audit and appeals.

Throughout the book, the author comments on various tax rules and offers his view of possible tax treatments in the areas that have not been addressed or clearly addressed by the law, regulations, and other authorities. Such commentary and interpretations, of course, are subject to error and may not necessarily agree with the interpretation of the Chinese tax authorities.

The book is written based on the materials available to the general public through November 26, 2010. Some of the tax rules or their interpretations may change subsequent to such date.

Finally, I would like to thank Megan Fu, Jiang Zhou, and Sindy Meng for their assistance in the production of this book

Fuli Cao
Beijing, China
November 2010

1

INTRODUCTION

1.1 Legal Framework—Sources of Law and Regulations and Their Implementation

China taxes are collected by different tax authorities based on various bodies of law and regulations. This section introduces the sources of tax laws and regulations in general, and the authority of relevant government agencies in relation to promulgation and enforcement of tax laws and regulations. This tax legislation and these regulatory frameworks apply to all categories of taxes, including Corporate Income Tax (the CIT).

1.1.1 TAX LAWS

Tax laws are promulgated by the National People's Congress of the People's Republic of China (the NPC) and the Standing Committee of the NPC. The NPC is the unicameral body vested with the authority to establish laws in China.[1] The NPC is composed of deputies elected by the provinces, autonomous regions, municipalities directly under the central government, and special administrative regions, as well as the armed forces.[2]

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[1] Article 58 of Constitution of the People's Republic of China (PRC).

[2] Article 59 of Constitution of the PRC.

The NPC holds a session once every year.[3] The powers of the NPC include the formulation and amendment of fundamental laws related to criminal offenses, civil affairs, state institutions, and other matters.[4]

The Standing Committee of the NPC can enact and revise laws other than those properly formulated by the NPC. When the NPC is not in secession, the Standing Committee can enact amendments and additions to the laws passed by the NPC, provided that the basic principles of these laws are not contravened. The Standing Committee can interpret all the laws.[5]

Fundamental tax systems must be in the form of law.[6] Corporate Income Tax Law (the CIT Law) is one of the important tax laws passed by the NPC.

1.1.2 TAX REGULATIONS ISSUED BY THE STATE COUNCIL

The State Council is the executive branch of China, the highest organ of state power and of state administration.[7] The State Council is given a number of functions and powers, including but not limited to the adoption of administrative measures, rules, and orders.[8] The tax regulations issued by the State Council mainly consist of following three types:

(1) Implementation Rules of Tax Law

A tax law enacted by the NPC or the Standing Committee of the NPC usually sets forth principles and some important provisions. The law often authorizes the State Council to issue the implementation rules of the law. The State Council then issues detailed implementation rules interpreting some of the articles contained in the tax law. Such implementation rules must be consistent with the principles provided in the tax law. However, the tax law often gives the State Council broad power to interpret the law. Accordingly, the implementation rules sometimes provide new rules where the law is silent, such as the Detailed Rules for the Implementation of PRC Corporate Income Tax Law (the CIT Implementation Rules).

(2) Provisional Tax Regulations

China Legislation Law requires that major taxes be regulated by law.[9] However, in the event that no law has been enacted regarding certain matters, the NPC and the Standing

[3] Article 61 of Constitution of the PRC.

[4] Article 62 of Constitution of the PRC.

[5] Article 67 of Constitution of the PRC; Article 7 of the Legislation Law of the PRC.

[6] Article 8 of the Legislation Law of the PRC.

[7] Article 85 of Constitution of the PRC.

[8] Article 89 of Constitution of the PRC.

[9] Article 8 of the Legislation Law of the PRC.

Committee of the NPC may authorize the State Council to enact administrative regulations concerning the relevant matters as needed.[10] Accordingly, the State Council in practice exercises the power to introduce and abolish taxes and change tax rates in the areas in which no tax law has been enacted. Various indirect taxes have been introduced and governed by provisional tax regulations issued by the State Council. These taxes currently include, et alia, Value-added Tax, Business Tax, Consumption Tax, City Maintenance and Construction Tax, Resources Tax, Land Appreciation Tax, Property Tax, Vehicle and Ship Tax, Stamp Duty, and Deed Tax.

(3) Interpretational Tax Circulars

The State Council may issue notices or other forms of circulars interpreting tax implementation rules and the provisional tax regulations. These circulars often address principal areas, while detailed tax circulars are issued by the Ministry of Finance (the MOF) and the State Administration of Taxation (the SAT).

1.1.3 TAX REGULATIONS ISSUED BY THE MOF AND THE SAT

The MOF is directly under the State Council. One area of responsibility of the MOF is to propose and implement tax policies. It can propose tax legislation plans; review and submit tax laws and regulations working together with the SAT; make tax revenue plans; propose the increase or decrease of categories of taxes, adjustment to tax rates, and tax incentives; participate in international tax and customs negotiations; and sign international tax treaties. It is also responsible for day-to-day work for the State Council Tariff Committee. The organization chart of the MOF is shown in Diagram 1.1.3-1. Tax Policy Department is the main office in charge of tax policy matters with the MOF. The department works closely with the SAT in proposing tax policies, drafting tax law and regulations, and issuing tax interpretation circulars. Diagram 1.1.3-1. details major divisions of Tax Policy Department of the MOF and their responsible areas of taxes.

The SAT is a ministry-level department directly under the State Council in charge of the tax policy and tax collection. SAT's responsibilities include, among others, drafting tax laws and regulations, formulating detailed implementation rules for tax laws and regulations, working together with the MOF to propose tax policies, organizing collection and administration of taxes, negotiating and implementing international tax agreements, overseeing the tax authorities at provinces, autonomous regions, and municipalities. The organization chart of the SAT is shown in Diagram 1.1.3-2.

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[10] Article 9 of the Legislation Law of the PRC.

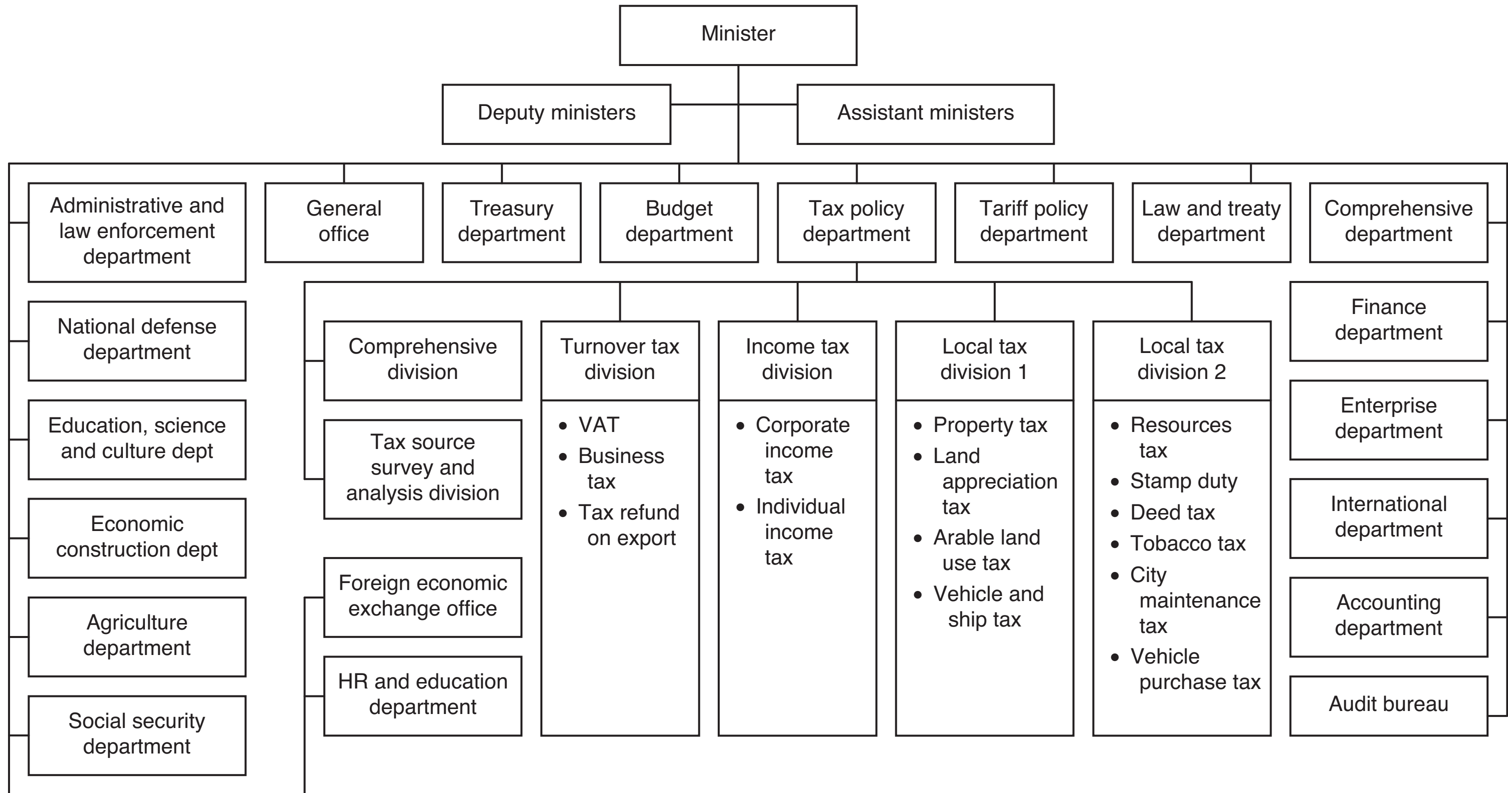

DIAGRAM 1.1.3-1 Organization of the Ministry of Finance

Source: http://www.mof.gov.cn

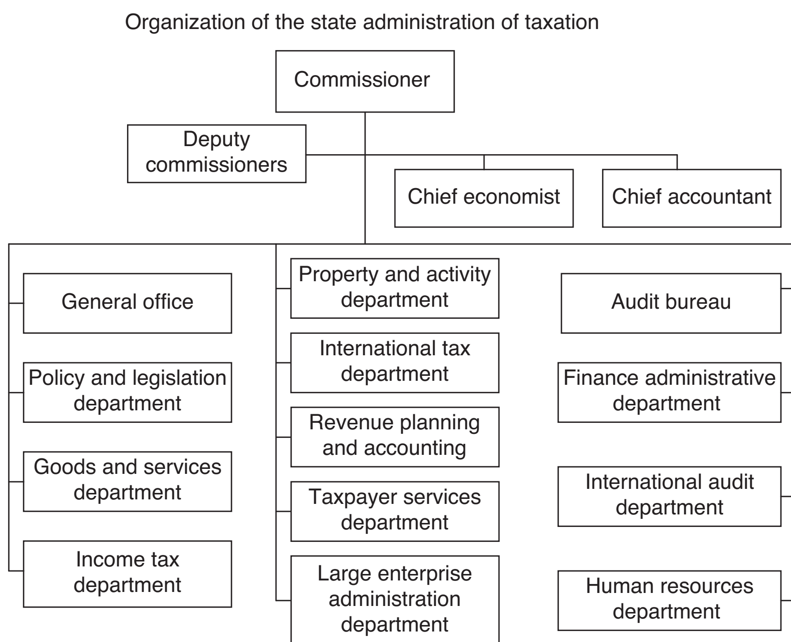

DIAGRAM 1.1.3-2 Organization of the State Administration of Taxation
Source: http://www.chinatax.gov.cn

Both the MOF and the SAT issue tax administrative rules and regulations. The major forms of these rules and regulations are as follows:

(1) The Implementation Rules of Provisional Tax Regulations

As discussed in 1.1.2, the State Council issues various administrative regulations on indirect taxes in the form of provisional tax regulations where no tax law has been enacted. The MOF and the SAT issue detailed rules for implementation of these provisional tax regulations issued by the State Council. In the past, some of the implementation regulations were issued by the MOF alone. In recent years, those implementation regulations were often jointly issued by the MOF and the SAT.

(2) Tax Interpretation Circulars

In addition to the detailed rules for implementation regulations, the MOF and the SAT have issued various documents to interpret tax law and regulations. Those documents, which are often called tax circulars, include order, notice, opinion, measures, reply, and letter reply. The SAT alone issues many tax circulars; many of those concern CIT issues. For important issues, tax circulars are often jointly issued by the MOF

and the SAT. A tax circular has a document number in a standard format, which usually identifies the issuing organization or one of the issuing organizations, form, year, and numerical number. The major forms of published tax circulars based on the document numbers are as follows:

Order of MOF and SAT. This is a circular jointly issued by the MOF and the SAT. It is often used to promulgate tax implementation rules and other important tax regulations. The order should be signed off by the Minister of Finance and the Commissioner of the SAT.[11] An order is often a very short document; the tax regulation issued via the order will be attached to the order. In this book, in reference footnotes, the document number of the order is usually cited, rather than the name of the regulations issued by an Order of MOF and SAT. The similar form of citation is also used for other types of tax circular issuing rules in an appendix to the circular.

Cai Shui. "Cai" is the first character of the MOF; "Shui" means "Tax." Many important tax circulars are jointly issued by the MOF and the SAT. Most of those jointly issued circulars are in the form of Cai Shui. Some of them issued in early years may be called Cai Shui Zi. Such a document can be initially drafted by the SAT and will be forwarded to the MOF for comments, revision, and sign-off. Conversely, a document may be initially prepared by the MOF and then co-signed by the SAT. The Minister or a Deputy Minister of the MOF and the Commissioner or a Deputy Commissioner of the SAT will sign off on the document.

SAT Order. Similar to the Order of MOF and SAT, the SAT Order is an order issued by the SAT alone, which often used to issue important tax rules. The SAT Order must be signed off by the Commissioner of the SAT.

SAT Gong Gao. "Gong Gao" means public notice. Prior to July 1, 2010, the SAT occasionally used "SAT Gong Gao" to announce a tax position or administrative procedural matters. On and after July 1, 2010, "Gong Gao" is the primary form for the SAT to interpret tax law and regulations that apply to taxpayers or withholding agents in a broad base (i.e., not a document that applies to only one taxpayer). "Gong Gao" should be used if the content of the document concerns the rights and obligations of taxpayers or withholding agents. SAT Gong Gao is issued to the general public; it should be implemented according to the document itself without the requirement of forwarding by lower levels of tax bureau.[12]

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[11] Article 47 of the Working Rules of Ministry of Finance, Cai Ban [2008] No. 27, issued by the MOF on June 10, 2008; Article 32 of the Working Rules of the State Administration of Taxation, Guo Shui Fa [2003] No. 56, issued by the SAT on May 27, 2003.

[12] Article 2 of the Measures on Administration of Issuing Regulatory Documents, SAT Order No. 20, issued by the SAT on February 10, 2010 and effective on July 1, 2010; Article 4 of the Notice on the Implementation of the Measures on Administration of Issuing Regulatory Documents, Guo Shui Fa [2010] No. 55, issued by the SAT on June 1, 2010.

Guo Shui Fa. "Guo Shui" means "State Tax"; "Fa" means "Issuing." This is a tax circular issued by the SAT to the tax bureaus at the provincial level and the tax bureaus in the cities specifically designated in the state plan.[13] Most of those address specific tax issues and provide guidance to implementation of tax law and regulations. As the document is officially issued to the provincial level of tax bureaus, the provincial level of tax bureaus would have to forward the circular to lower levels of tax bureaus for implementation. Guo Shui Fa was widely used by the SAT prior to July 1, 2010. On and after July 1, 2010, Guo Shui Fa cannot be used to address tax matters involving the rights and obligations of taxpayers or withholding agents; SAT Gong Gao is required to be used instead.

Guo Shui Han. "Han" means "letter." Guo Shui Han is a tax circular in the form of letter from the SAT. A similar form of circular issued in early years may also be called "Guo Shui Han Fa." Guo Shui Han was used by the SAT to interpret tax treaties, law, and regulations in various situations. The SAT often issued Guo Shui Han in three situations. The first type of Guo Shui Han was to address tax issues without specific request from other organizations. This type of letter was often issued to all tax bureaus at the provincial level and the tax bureaus in the cities specifically designated in the state plan. The second type of Guo Shui Han is a letter responding to a written request made by a tax bureau at provincial level or a tax bureau in a city specifically designated in the state plan. When a tax bureau encounters difficulty to determine tax treatment of a specific issue, the tax bureau can seek guidance from a tax bureau at a higher level. For example, a district bureau can seek guidance from city tax bureau. A tax bureau may decide to write a formal letter to seek such guidance. If a tax bureau at the provincial level or a tax bureau in a city separately designated in the state plan submits a letter request to the SAT and the SAT decides to reply to the tax bureau in writing, the SAT would issue a Guo Shui Han. A published Guo Shui Han can serve as official interpretation of tax law and regulations, although technically they are issued only to the specific tax bureaus for specific cases. The third type of Guo Shui Han is a letter reply to some large state-owned enterprises that are equivalent to a ministry level. Those enterprises can write to the SAT directly concerning tax issues. The SAT can reply to those enterprises in the form of Guo Shui Han. They often request approval of certain tax benefits. One example is application for certain tax exemptions in connection with reorganization for listing on stock exchange. These letters tend to apply to the enterprise only. On and after July 1, 2010, Guo Shui Han cannot

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[13] A city specifically designated in the state plan refers to a city, other than a municipality directly under the central government, that is within a province, but is treated separately from the province for state planning purpose. Politically, a city specifically designated in the state plan is administrated by the province. The revenue and expenditures of the city, however, are directly linked with the central government. Currently there are five cities specifically designated in the state plan, including Dalian, Ningbo, Qingdao, Shenzhen, and Xiamen. The state tax bureaus in the cities specifically designated in the state plan report to the SAT directly.

be used to address tax matters involving the rights and obligations of taxpayers or withholding agents; SAT Gong Gao generally is required to be used instead.

Circulars issued by departments of the SAT. Some circulars are issued by departments of the SAT. Most of those published circulars are in the form "Bian Han." The direct translation of it is "informal letter." The abbreviation of an issuing department is added before "Bian Han." For example, "Ji Bian Han" is issued by the International Tax Department of the SAT. "Ji" represents International Tax Department. "Qi Bian Han" is issued by Large Enterprise Administration Department. "Bian Han" should no longer be a valid form of circular to address tax matters involving the rights and obligations of taxpayers or withholding agents on and after July 1, 2010.

Other forms of tax circulars. The MOF and the SAT also issued other forms of tax circulars. Many of those were issued in early years. The predecessor of the SAT is the Administration of Taxation of the MOF. In May 1988, the SAT was formed and became an agency under the Sate Council. However, the SAT was under the administration of the MOF till 1993. Since 1993, the SAT reported directly to the State Council. As such, most tax circulars prior to May 1993 were issued by the MOF alone. Those early circulars concerning the CIT issues should no longer be valid, as they were issued under the old tax law and regulations, and have been replaced by the CIT Law and the CIT Implementation Rules.

Circulars jointly issued with other government offices. The MOF and the SAT sometimes jointly issue circulars with other government offices. When a new government policy requires the issuance of tax rules to implement, the MOF and the SAT may join with other relevant government offices to issue circulars. Other government offices may include the National Development and Reform Commission, the Ministry of Commerce, the State Administration for Industry and Commerce, the State Administration of Foreign Exchange, the General Administration of Customs, and the Ministry of Science and Technology.

1.2 Development of Corporate Income Tax System

1.2.1 1949–1980: EARLY TAXATION SYSTEM OF NEW CHINA

The People's Republic of China (PRC) was established on October 1, 1949. In 1950, the Government Administration Council, the predecessor of the State Council, issued the Key Rules of Implementing State Tax Policies, which provided fourteen types of national taxes, including three types of income tax: Industry and Commerce Tax (income tax portion), Interest Tax on Bank Deposit, and Salary Tax. The State started to collect Industry and Commerce Tax in 1950. The tax was primarily imposed on private enterprises, collectively owned enterprises, and sole proprietorships. The State-owned enterprises dominated the economy. State-owned enterprises did not pay income tax. Instead, State-owned enterprises paid profits to the State.

1.2.2 1980–1990: MULTIPLE TAX SYSTEMS IN EARLY YEARS OF CHINA'S OPEN DOOR POLICY AND ECONOMIC REFORM

In 1978, China started economic reform and open door policy. On July 1, 1979, the Committee of the NPC passed the PRC Sino-Foreign Joint Venture Law. On April 12, 1986, the NPC passed the Law of the PRC Concerning Wholly Foreign Owned Enterprises. On April 13, 1988, the NPC passed the Law of the PRC Concerning Sino-Foreign Cooperative Joint Ventures. Direct foreign investments in China are allowed under these laws. Most foreign investments were in the form of Chinese-foreign equity joint ventures and Chinese-foreign cooperative joint ventures in the early period of China's economic reform. However, wholly foreign owned enterprises (WFOE) were permitted in some industries in China then.

In September 1980, the NPC passed the Income Tax Law of the PRC for Sino-Foreign Equity Joint Ventures.[14] The income tax rate was 33 percent, including 30 percent national tax and 3 percent of local tax.[15] In December 1981, the NPC passed the Income Tax Law of the PRC for Foreign Enterprises.[16] Foreign enterprises defined in the tax law include foreign enterprises directly operating in China, China branches of foreign enterprises, and foreign enterprises participating in Sino-Foreign cooperative joint ventures.[17] Progressive tax rates of 20 percent to 40 percent were applicable to foreign enterprises.[18] Additionally, local tax at 10 percent of national tax was imposed.[19] As such, the combined national and local tax rates for foreign enterprises were 22 percent to 44 percent.

For domestic enterprises, in 1983, the State Council decided to try out the "reform from profit to tax" for State-owned enterprises. Under the new policy, State-owned enterprises would pay income tax rather than simply give all or most profits to the State. On September 18, 1984, the NPC passed a resolution to authorize the State Council to issue provisional regulations in draft form to implement the reform of "from profit to tax" for State owned enterprises. In September 1984, the State Council issued the Provisional Regulations of the PRC on Income Tax for State Owned Enterprises (Draft)[20] and the Measures on Collection of Adjusted Tax for State Owned Enterprises.[21]

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[14] The Income Tax Law of PRC for Sino-Foreign Equity Joint Ventures, passed by the third session of fifth NPC on September 10, 1980 and effective from September 10, 1980 to June 30, 1991.

[15] Article 3 of the Income Tax Law of PRC for Sino-Foreign Equity Joint Ventures.

[16] The Income Tax Law of the PRC for Foreign Enterprises, passed by the fourth session of fifth NPC on December 13, 1981 and effective from January 1, 1982 to June 30, 1991.

[17] Article 1 of the Income Tax Law of the PRC for Foreign Enterprises.

[18] Article 3 of the Income Tax Law of the PRC for Foreign Enterprises.

[19] Article 4 of the Income Tax Law of the PRC for Foreign Enterprises.

[20] The Provisional Regulations of the PRC on Income Tax for State Owned Enterprises (Draft), issued by the State Council on September 18, 1984 and implemented from October 1, 1984 to December 31, 1993.

[21] The Measures on Collection of Adjusted Tax for State Owned Enterprises, issued by the State Council on September 18, 1984 and implemented from October 1, 1984 to December 31, 1993.

Large- and medium-sized State-owned enterprises were subject to a 55 percent income tax; small-sized state-owned enterprises were subject to income tax at progressive rates between 10 percent and 55 percent.[22] Large- and medium-sized State-owned enterprises were also subject to adjusted tax, and the tax rates were determined by the finance and tax departments based on adjusted 1983 profits.[23]

In April 1985, the State Council issued the Provisional Regulations of the PRC on Income Tax for Collectively Owned Enterprises.[24] The collective owned enterprises were subject to income tax at 10 percent to 55 percent.[25] At the same time, China stopped implementing Industry and Commercial Tax (Income Tax Portion) for collectively owned enterprises.

In June 1988, the State Council issued the Provisional Regulations of the PRC on Income Tax for Private Enterprises.[26] The tax rate was 35 percent.[27]

1.2.3 TAX REFORMS OF 1991 AND 1993—TWO CORPORATE INCOME TAX SYSTEMS

On April 9, 1991, the NPC passed the Income Tax Law of the PRC for Foreign Invested Enterprises and Foreign Enterprises (FEIT Law), which unified and replaced the Income Tax Law of PRC for Sino-Foreign Joint Ventures and the Income Tax Law of the PRC for Foreign Enterprises. FEIT Law was effective from July 1, 1991 to December 31, 2007.

On December 13, 1993, the State Council issued the Provisional Regulations of the PRC on Enterprise Income Tax (EIT Regulations). The EIT Regulations unified and replaced the Provisional Regulations of the PRC on Income Tax for State Owned Enterprises (Draft), the Measures on Collection of Adjusted Tax for State Owned Enterprises, the Provisional Regulations of the PRC on Income Tax for Collectively Owned Enterprises, and the Provisional Regulations of the PRC on Income Tax for Private Enterprises. The EIT Regulations were effective from January 1, 1994 to December 31, 2007.

As a result of income tax reforms in 1991 and 1993, the multiple income tax systems were simplified into two systems.

FEIT Law was applicable to all foreign invested enterprises and foreign enterprises. Foreign invested enterprises generally are enterprises established in China with direct

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[22] Article 4 of the Provisional Regulations of the PRC on Income Tax for State Owned Enterprises (Draft).

[23] Articles 1 and 6 of the Measures on Collection of Adjusted Tax for State Owned Enterprises.

[24] The Provisional Regulations of the PRC on Income Tax for Collectively Owned Enterprises, issued by the State Council on April 11, 1985 and effective from January 1, 1985 to December 31, 1993.

[25] Article 3 of the Provisional Regulations of the PRC on Income Tax for Collectively Owned Enterprises.

[26] The Provisional Regulations of the PRC on Income Tax for Private Enterprises, issued by the State Council on June 25, 1988 and effective from January 1, 1988 to December 31, 1993.

[27] Article 3 of the Provisional Regulations of the PRC on Income Tax for Private Enterprises.

foreign equity investment of 25 percent or more, which include Sino-Foreign equity joint ventures, Sino-Foreign cooperative joint ventures, and wholly foreign owned enterprises. Foreign enterprises include foreign corporations, foreign partnerships, and any other forms of foreign organizations. FEIT Law was also applicable to China branches and representative offices of foreign enterprises.

EIT Regulations were applicable to all Chinese enterprises other than foreign invested enterprises and sole proprietorships. Those Chinese enterprises are commonly called domestic enterprises. Sole proprietorships are subject to Individual Income Tax at rates of 5 percent to 35 percent of profits.[28]

The regular tax rate under both FEIT law and the EIT Regulations was the same, 33 percent.[29] However, more tax incentives were available under FEIT Law and its implementation regulations than those under the EIT Regulations and its implementation rules. For example, all production foreign invested enterprises with an operating term of more than ten years were entitled to income tax exemption for two years from the first profit-making year and a 50 percent reduction in income tax rate for the following three years. Certain foreign invested enterprises established in some designated areas enjoyed 15 percent or 24 percent income tax rates. Domestic enterprises, on the other hand, were generally not eligible for such a wide range of tax incentives. Furthermore, domestic enterprises were subject to more limitations on deduction of expenses in computing taxable income than those for foreign invested enterprises. For example, foreign invested enterprises can deduct salary expenses on actual basis; domestic enterprises generally were subject to salary expense limitations.[30] As a result, the average effective tax rate for foreign invested enterprises was much lower than that for domestic enterprises.

1.2.4 TAX REFORM OF 2007—UNIFICATION OF TWO TAX SYSTEMS

The tax incentives under FEIT Law played a positive role in attracting foreign investments to China. The different tax burdens for domestic enterprises and foreign invested enterprises under the two tax systems, however, resulted in unfair competition. The two systems require higher administrative costs for tax collection. As the five-year transition period under China WTO commitment was phased out, more and more sectors were

[28] Article 3 of Individual Income Tax Law of the PRC.

[29] The FEET rate of 33 percent included 30 percent national tax and 3 percent local income tax according to Article 5 of FEIT Law; Enterprise Income Tax contained only one rate without differentiation between national and local income tax under Article 3 of EIT Regulations.

[30] The standard limitations for salary expense deduction for domestic enterprises were RMB500 per person per month for 1994 and 1995, RMB550 per person per month from 1996 to 1999, RMB800 per person per month from January 1, 2000 to June 30, 2006, and RMB1600 per person per month from July 1, 2006 to December 31, 2007. Upon the approval of the Ministry of Finance and the SAT, the governments at provincial level could increase the limitation up to 20% of the standard limitations for the periods prior to June 30, 2006.

open to foreign investments. The preferential tax treatment for foreign investment is not in violation of WTO rules, but more and more demand for equal tax treatment was voiced by domestic enterprises. On March 16, 2007, the NPC passed the CIT Law. The CIT Implementation Rules were approved by the State Council on November 28, 2007 and issued by Order of State Council on December 6, 2007. Both the CIT Law and the CIT Implementation Rules came into effect on January 1, 2008.

The CIT Law unified the two corporate income tax systems. The law applies to all enterprises including domestic enterprises, foreign invested enterprises, and foreign enterprises. The following chapters of this book will address in detail the provisions of the CIT Law, the CIT Implementation Rules, and major tax circulars interpreting them.

2

TAXPAYERS

Enterprises defined under the CIT Law include business enterprises and other types of organizations receiving income.[1] Taxpayers for CIT purposes include not only corporations but also other types of entities. However, partnerships organized in China and sole proprietorships are not taxpayers for CIT purposes. The CIT Law classifies taxpayers into resident taxpayers and non-resident taxpayers. Resident taxpayers are subject to CIT on its worldwide income; non-resident taxpayers are subject to CIT only on its income derived from China.

2.1 Resident Enterprise

A resident enterprise is an enterprise that is established in the PRC under the PRC laws, or an enterprise that is established under the laws of foreign countries or regions but whose place of effective management is located in the PRC.[2]

[1] Article 1 of the CIT Law.

[2] Article 2 of the CIT Law.

2.1.1 ENTERPRISES ORGANIZED UNDER CHINESE LAWS

Enterprises established under Chinese laws include business enterprises public institutions, social organizations, and other revenue-generating organizations that are established in accordance with the laws and administrative regulations of the PRC.[3]

2.1.1.1 Domestic Companies

All domestic companies established in accordance with the Company Law are resident taxpayers. The Company Law of the PRC authorizes two types of companies, limited liability companies and joint stock limited companies. Both types are corporations with limited liability where shareholders are liable for the debt of the company to the extent of the capital contributed or shares subscribed. The number of shareholders of a limited liability company is limited to fifty. The minimum registered capital of a limited liability company is RMB30,000[4]. If a limited liability company has a single-shareholder, its minimum registered capital must be at least RMB100,000.[5] The law and administrative regulations other than the Company Law may require higher minimum registered capital for some types of companies in some industries, such as banking or insurance. The amount of minimum registered capital of a limited liability company under the Company Law is subject to the capital requirements for specific industries under those laws or administrative regulations.[6]

A joint stock limited company currently is the only form of entity that can be listed on China stock exchanges. Joint stock limited companies are usually formed with intention to list the companies within China. There is no limitation on the number of shareholders for joint stock limited companies. However, one of the requirements to establish a joint stock limited company is that there should be two to two hundred promoters, of whom a majority shall be domiciled within the territory of China.[7] The minimum registered capital of a joint stock limited company is RMB 5 million.[8] Similar to limited liability companies, the amount of minimum registered capital of joint stock limited companies is subject to the capital requirements for specific industries under any law or administrative regulations.[9]

[3] Article 3 of the CIT Implementation Rules.

[4] Article 26 of the Company Law.

[5] Article 59 of the Company Law.

[6] Articles 26 of the Company Law.

[7] Article 79 of the Company Law.

[8] Article 81 of the Company Law.

[9] Article 81 of the Company Law.

2.1.1.2 Foreign Invested Enterprises

Foreign invested enterprises refer to Chinese entities established under Chinese foreign investment law and regulations. They typically include Chinese-foreign equity joint ventures, Chinese-foreign cooperative joint ventures, and -WFOE.

Chinese-foreign equity joint ventures. A Chinese-foreign equity joint venture is a company established under the PRC Chinese-Foreign Equity Joint Venture Law. It is a limited liability company. The foreign ownership in an equity joint venture should not be less than 25 percent. The profits and losses are shared according to the ratio of each owner's capital contribution to the equity joint venture. A Chinese-foreign equity joint venture is a Chinese resident taxpayer.

Chinese-foreign cooperative joint ventures. A Chinese-foreign cooperative joint venture is an entity established under the PRC Chinese-Foreign Cooperative Joint Venture Law. In contrast to an equity joint venture, a cooperative joint venture may distribute profits based on the terms of contract among its owners, rather than based on the ratio of capital contribution. There are two types of cooperative joint ventures, one of which is in the form of a limited liability company, a Chinese legal person. This type of cooperative joint venture is a resident taxpayer.

Another type of cooperative joint venture is a non-legal person cooperative joint venture. The owners of a non-legal person cooperative joint venture are liable for the liability of the joint venture.[10] This legal characteristic is similar to that of a general partner in a partnership. The CIT Law and the CIT Implementation Rules do specifically address whether a non-legal person cooperative joint venture is a taxpayer for the CIT purpose. A literal reading of the CIT Law could result in the conclusion that a cooperative joint venture should be a resident enterprise because it is an enterprise established under Chinese law and not a partnership or a sole proprietorship. However, the similarity between the legal characteristics of a non-legal person cooperative joint venture and a partnership suggests that a non-legal person cooperative joint venture should be treated as a pass-through entity and the owners of the joint venture should pay CIT (if the owners are enterprises) or individual income tax (if the owners are natural persons). This conclusion is supported by legislative intent for the CIT Law. The reason for exclusion of partnerships and sole proprietorship is that those entities are not legal persons and their owners have infinite liabilities;[11] a non-legal person Chinese-foreign cooperative joint venture has the same legal characteristics. The requirement of the setup of separate accounting books by each party to a non-legal person cooperative joint venture, in addition to the accounting books of the joint venture itself, should also support the fiscally

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[10] Article 50 of the Detailed Rules for the Implementation of the PRC Sino-Foreign Cooperative Joint Venture Law.

[11] Article 5 of the Outlines for Promotion of the New Corporate Income Tax Law, Guo Shui Han [2008] No. 159, issued by the SAT on February 5, 2008.

transparent entity conclusion.[12] In practice, however, most cooperative joint ventures are in the form of limited liability company.

WFOE. A WFOE is a Chinese company established under the Law of the PRC Concerning Wholly Foreign Owned Enterprises. A WFOE is a legal form that is commonly used by a foreign company to set up a 100 percent owned subsidiary. A WFOE may have more than one owner as long as the owners are foreign enterprises and/or foreign individuals. People sometimes use the terms Foreign Investment Holding Company or Foreign Investment Commercial Enterprise (FICE). Those are classified by function of foreign invested enterprises. If Foreign Investment Holding Company and FICE are wholly foreign owned, those will be special types of WFOEs. WFOEs are Chinese resident taxpayers.

Foreign invested enterprises can be converted into foreign invested joint stock limited companies in order to be listed on China stock exchanges.[13] Such conversions will not change the resident enterprise status of the foreign invested enterprises for the CIT purposes.

2.1.1.3 Partnership

A partnership established under the PRC Partnership Law [14] is not a taxpayer for the CIT purposes. Each partner of a partnership is a taxpayer. If the partner is a Chinese corporation, the partner will be a Chinese resident taxpayer for the CIT purposes. If the partner is an individual, the partner will be subject to Individual Income Tax.[15] The partners of a partnership are taxed on their respective shares of operating income and other income of the partnership. The distribution of profits by a partnership to its partners is not a taxable event. The taxable income of a partner with respect to the income from partnership includes both the profit distributed to the partner and the partner's share of current retained earnings of the partnership.[16]

The income of partners of a partnership is determined based on the following:[17]

(1) If the partnership agreement provides for-profit sharing ratio, the taxable income of partners derived from the partnership shall be based on such ratio.

[12] Article 54 of the Detailed Rules for the Implementation of the PRC Sino-Foreign Cooperative Joint Venture Law.

[13] The Opinions on Relevant Issues Concerning Listed Companies with Foreign Investment, Wai Jing Mao Zi Fa [2001] No. 538, issued by the former Ministry of Foreign Trade and Economic Cooperation and China Securities Regulatory Commission on October 8, 2001.

[14] The PRC Partnership Law, passed by the NPC Standing Committee on February 23, 1997 and revised by the NPC Standing Committee on August 27, 2006.

[15] Article 2 of the Notice Concerning Income Tax Issues of Partners of Partnerships, Cai Shui [2008] No. 159, issued by the MOF and the SAT on December 23, 2008 and effective on January 1, 2008.

[16] Article 3 of Cai Shui [2008] No. 159.

[17] Article 4 of Cai Shui [2008] No. 159.

(2) If the profit sharing ratio is not clearly provided in the partnership agreement, the taxable income of partners can be determined based on the agreement of partners.
(3) If the partners are unable to decide the profit sharing ratio, all the partnership income shall be allocated based on the ratio of capital contribution to the partnership.
(4) If the capital contribution cannot be identified, all the partnership income will be equally allocated to each partner for determination of taxable income of the partner from the partnership.
(5) The partnership agreement cannot provide that all income will be allocated to some partners.

If a partner of a partnership is an enterprise, the partner cannot use its share of loss of the partnership to offset other income of the partner in computing the taxable income of the partner.[18] This limitation on the use of loss of partnership reduces the benefit of pass-through character of partnership. Essentially, the loss from a partnership will only be allowed to offset its own future profit. An enterprise partner will have to maintain a separate loss pool for each investment in partnership. If the share of loss cannot be used to offset the profit share from the partnership within five years following the loss sharing year, such unused loss will expire.

The PRC Partnership Law as amended in 2006 generally allows Chinese individuals and Chinese enterprises to form partnerships. The partnership law authorizes the State Council to issue administrative regulations concerning the establishment of partnerships in China by foreign enterprises and foreign individuals.[19] On November 25, 2009, the China State Council issued the Measures for the Establishment of Partnerships within China by Foreign Enterprises and Foreign Individuals.[20] According to the measures, foreign enterprises and foreign individuals are allowed to set up Chinese partnerships and participate in existing partnerships in China in accordance with the PRC Partnership Law on and after March 1, 2010. As a form of entity, a foreign invested partnership will provide foreign investors with flexibility in establishment procedures, capital contribution, and the increase or reduction of capital. For income tax purposes, similar to a domestic partnership, a foreign invested partnership is a fiscally transparent entity. The tax treatments of partnerships as discussed above should apply to foreign invested partnerships.

[18] Article 5 of Cai Shui [2008] No. 159.

[19] Article 108 of the PRC Partnership Law.

[20] The Measures for the Establishment of Partnerships within China by Foreign Enterprises and Foreign Individuals, Order of State Council No. 567, issued by the State Council on November 25, 2009 and effective on March 1, 2010.

A partnership organized under foreign laws is not treated as a transparent entity. The foreign partnership doing business in China is subject to the CIT Law. Foreign partnerships generally are treated the same as foreign corporations for China tax purposes. As such, if a foreign partnership's place of effective management is not in China, it will be a non-resident taxpayer.

2.1.1.4 Nonprofit Organizations

The qualified income of nonprofit organizations is exempted from the CIT.[21] In order to qualify for tax-exempted entity, a nonprofit organization must satisfy all of the following conditions[22]:

(1) It has completed the registration procedures required for nonprofit organization in accordance with the laws. It can be a publicly funded institute, a social group, a foundation, a private nonprofit entity, a place of religious activities, or any other organization determined by the MOF and the SAT;
(2) It is engaged in public welfare or nonprofit operations and its main activities are within the territory of China;
(3) Income derived by the organization is entirely used for the public welfare or nonprofit undertakings that are prescribed upon registration or in the Articles of Association, except for related and reasonable expenses of the organization;
(4) Its properties and the income or gains derived as a result of the holding of such properties are not used for distributions. Reasonable salary expenses are not considered as distribution;
(5) As authorized in its registration and stipulated in its Articles of Association, the remaining assets after deregistration of the organization are used for public welfare or nonprofit purposes, or are re-donated through registration and administrative authorities to other organizations of the same nature and missions, and the same are announced to the general public;
(6) The donors do not reserve or enjoy any rights in the assets that are donated to the organization. The donors here refer to any legal persons, individuals, and other organizations other than People's Governments at all levels and their departments;
(7) Salaries and welfare benefits of employees are limited by prescribed ratios, and properties of the organization are not distributed in a disguised form. The average salary of staff cannot exceed two times the average prior year salary at the

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[21] Article 26(4) of the CIT Law.

[22] Article 84 of the CIT Implementation Rules; Article 1 of the Notice on the Issues Concerning the Determination of Tax Exemption Status of Nonprofit Organizations, Cai Shui [2009] No. 123, issued by the MOF and the SAT on November 11, 2009 and effective on January 1, 2008.

location of the tax registration of the organization. The welfare for staff should comply with relevant regulations of the State;

(8) If the nonprofit organization is a publicly funded institute, a social group, a foundation, or a private nonprofit entity, it must receive a "qualified" result for its annual inspection for the preceding year unless the entity is set up and registered in current year; and

(9) The taxable income, if any, and related costs, expenses, and losses must be accounted separately from tax-exempted income and related costs, expenses, and losses.

If a nonprofit organization is approved by and registered with a registration agency at the provincial level or above, the organization should apply for tax-exemption status with the tax authority at the provincial level at its location. If a nonprofit organization is approved by and registered with a registration agency at the city (prefecture) or county level, the organization should apply for tax-exemption status with the tax authority at city (prefecture) or county level at its location. The finance and tax departments should assess and determine the tax-exemption status of nonprofit organizations within their jurisdictions and publish the names of qualified entities periodically.[23] The tax-exemption status is valid for five years. A nonprofit organization should apply for a renewal of the status within three months before the expiration date; otherwise, the nonprofit organization will automatically lose its tax exemption status.[24]

The exempted revenue of a qualified nonprofit organization does not include any revenue that is derived from for-profit operations of the organization, unless otherwise prescribed by the departments of the State Council in charge of finance and taxation.[25] The exempted revenue of a qualified nonprofit organization includes the following:[26]

(1) Donations received from other units or individuals;

(2) Government subsidies, excluding the revenue derived from the purchase of services by the governments;

(3) Membership fees collected as prescribed by the People's Governments or their finance departments at the provincial level or above;

(4) Interest on bank deposits of non-taxable revenue or tax-exempted revenue; and

(5) Other revenue as prescribed by the MOF and the SAT.

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[23] Article 3 of Cai Shui [2009] No. 123.

[24] Article 5 of Cai Shui [2009] No. 123.

[25] Article 85 of the CIT Implementation Rules.

[26] The Notice on the Issues Concerning the Revenue of Non-profit Organizations that is Exempted from Corporate Income Tax, Cai Shui [2009] No. 122, issued by the MOF and the SAT on November 11, 2009 and effective on January 1, 2008.

2.1.2 ENTERPRISES ORGANIZED UNDER FOREIGN LAWS

An enterprise is considered to be a resident enterprise if it has its place of effective management in China,[27] although not established under Chinese law. A "place of effective management" refers to an establishment that exercises substantive and overall management and control over the production and business operations, personnel, financial functions, properties, etc. of an enterprise.[28] The CIT Law and the CIT Implementation Rules did not offer clear guidance regarding the specific factors that determine management and control, which leaves ample room for interpreting these terms to the tax authorities. It appears from the broad definition of effective management that a non-resident board and board meetings outside China may not be sufficient for a classification of an offshore entity as a non-resident enterprise for China tax purposes.

There are three categories of foreign registered companies, based on ownership, that may be exposed to this rule.

The first category is foreign registered companies that are founded and controlled by Chinese domestic enterprises. Those foreign registered companies are typically foreign listing vehicles for China State-owned enterprises. For example, a State-owned enterprise, a Chinese registered company, will set up an offshore holding company. The offshore holding company will own operating companies in China. The offshore company then is listed in a foreign stock exchange. After the foreign listing, the State-owned enterprise would directly or indirectly own majority shares of the offshore listing company.

The SAT issued Guo Shui Fa [2009] No. 82,[29] which provides guidelines for the determination of a resident enterprise on the basis of the place of effective management in China. Those guidelines apply only to the first category of foreign registered companies. The tax circular refers to them as "overseas China-funded enterprises," which are defined as enterprises established under the laws of foreign countries (regions) and for which the main investors are enterprises or enterprises groups within the territory of China.[30] An overseas China-funded enterprise satisfying all the following conditions will be considered as a resident enterprise by reason of place of effective management in China:[31]

(1) Senior management and senior management departments that are responsible for daily production, operation and management of the enterprise perform their duties mainly within China;

[27] Article 2 of the CIT Law.

[28] Article 4 of the CIT Implementation Rules.

[29] The Notice on the Relevant Issues Concerning the Criteria for the Determination of Enterprises Registered Overseas and Controlled by Chinese Enterprises as a Resident Enterprise on the Basis of Place of Effective Management, Guo Shui Fa [2009] No. 82, issued by the SAT on April 22, 2009 and effective on January 1, 2008.

[30] Article 1 of Guo Shui Fa [2009] No. 82.

[31] Article 2 of Guo Shui Fa [2009] No. 82.

(2) Financial decisions (such as money borrowing, lending, financing and financial risk management) and personnel decisions (such as appointment, dismissal, salary, and wages) are made or need to be approved by organizations or persons located within China;
(3) Main property, accounting books, corporate seal, and records of meetings of the board of directors and shareholders of the enterprise are maintained in China; and
(4) One half or more of the members of the board of directors or the senior management staff of the enterprise habitually reside in China.

In spite of the requirement that "all must be met," the SAT provides that the determination should be made based on the principle of substance over form.[32] Those provisions seem to give the tax authorities flexibility to determine whether an overseas China-funded enterprise is a resident enterprise. On one hand, the tax authorities can deny an application for China resident enterprise status by an overseas China-funded enterprise if any of the four criteria is not met. On the other hand, the tax authorities can determine an overseas China-funded enterprise as a China resident enterprise based on the principle of substance over form, where some of the conditions are not met (e.g., merely keeping the corporate seal outside China).

The main reason for issuing the above guidelines is that it seems to provide implementation procedures for overseas China-funded enterprises to register themselves as China resident enterprises for CIT purposes, to eliminate double taxation. Some State-owned enterprises set up overseas holding companies (e.g., in the Cayman Islands or Hong Kong) and list the overseas holding companies on stock exchanges outside China; the overseas holding companies own operating companies in China. If the overseas holding companies are non-resident enterprises, the dividends paid by Chinese operating companies will be subject to China withholding tax. Furthermore, when the overseas holding companies pay dividend to the top Chinese parent companies, the Chinese parent companies would have taxable income subject to CIT; CIT paid by the operating companies and the overseas holding companies are not creditable because they are not foreign income tax. A registration of the overseas holding companies as a China resident enterprise for CIT purposes will make the dividends from the operating companies to the overseas holding companies, and from the overseas companies to the top Chinese parent companies, as the dividends between China resident enterprises that are exempted from CIT. The main beneficiaries of the guidelines are State-owned enterprises that control overseas holding companies. Although the rule technically is also applicable to overseas companies controlled by other domestic enterprises, it is not common for privately owned companies to have a double-sandwich structure, in which both top parent and bottom operating entities are China registered companies.

[32] Article 3 of Guo Shui Fa [2009] No. 82.

The second category of foreign registered companies is similar to the first category except the offshore companies are formed by individuals who live in China, rather than Chinese companies. A typical and simplified structure of this type of companies is that the individuals form an offshore holding company. The offshore holding company then owns one or more WFOEs in China. One of the reasons for the offshore structure is to obtain foreign funding. Foreign private equity funds can directly invest in the offshore holding company, which in turn channels the fund into China operating entities. Eventually, the offshore holding company will be listed in a stock exchange in a foreign country or Hong Kong. Offshore holding companies in this category may fall into the definition of "effective management" in China under the CIT Law and the CIT Implementation Rules. Guo Shui Fa [2009] No. 82 does not apply to this category of foreign registered companies because those offshore companies are not controlled by Chinese enterprises. However, in the absence of specific guidance, the factors of determining the place of effective management provided in Guo Shui Fa [2009] No. 82 could be used as a reference. The Chinese tax authorities have not tried to tax those offshore companies as Chinese resident enterprises in practice for the moment.

The third category of foreign registered companies is that of offshore holding companies set up by foreign companies or individuals to invest in a Chinese entity. The top foreign companies usually are multinational corporations having substantial operations outside China. Those foreign companies would be non-resident enterprises. An offshore holding company, however, may be an entity that only holds equity interest in one or more Chinese companies. The question is whether the offshore holding company can be a Chinese resident enterprise. The risk exists where the directors and officers of the offshore holding company are also officers of Chinese operating companies. In such a situation, the offshore holding company could be viewed as effectively managed in China and therefore a China resident enterprise. Similar to the second category of foreign registered companies, Guo Shui Fa [2009] No. 82 does not apply to this third category of foreign registered companies. However, in the absence of specific guidance, the factors of determining the place of effective management provided in Guo Shui Fa [2009] No. 82 could be used as a reference. The Chinese tax authorities have not tried to tax those offshore companies as Chinese resident enterprises in practice for the moment. The risk of Chinese resident enterprise can be mitigated by ensuring that the offshore holding companies do not meet all or most of the effective management factors listed in Guo Shui Fa [2009] No. 82.

2.2 Non-Resident Enterprise

Non-resident enterprises can be taxed in China in two ways. One is to carry on a trade or business in China; another is to derive China source income that is not connected with an establishment in China.

2.2.1 FOREIGN COMPANY CARRYING ON TRADE OR BUSINESS IN CHINA

A non-resident enterprise is liable for Chinese income tax on its income derived from China. If a non-resident enterprise has an establishment or place of business in China, the enterprise is subject to China tax on its income from China and overseas that is effectively connected to the establishment or place of business in China.

2.2.1.1 Establishment or Place of Business under Domestic Law

The term "establishment or place of business" in the CIT Law and the CIT Implementation Rules covers a broader range of activities than does the "permanent establishment" as provided in tax treaties. An establishment or place of business includes (1) a management establishment, a business office, or an office; (2) the places used as farm, factory, and exploitation of natural resources; (3) a place where services are provided; (4) a place where a project of construction, installation, repair, exploration, etc. is carried out; and (5) other establishments or places of business where production and business operations are carried out.[33]

Under the broad definition of establishment or place of business, any fixed place of business of a foreign enterprise in China will subject the foreign enterprise to CIT. Even if the foreign enterprise does not have a fixed place of business in China, if "the place of provision of services" is in China, a foreign company may be subject to the CIT from the first day when the foreign enterprise provides services in China.

If a non-resident enterprise carries out production and business operations through a business agent in China, the business agent will be considered as an establishment or place of business of the non-resident enterprise. The CIT Implementation Rules define "business agent" as any entity or individual carrying on production or business activities in China on behalf of a non-resident enterprise, including habitually concluding contracts on behalf of the non-resident enterprise, storing or delivering the goods of the non-resident enterprise.[34]

The provision of a business agent exposes non-resident enterprises to the CIT in various common business models. For example, a contract processing arrangement is used as export processing where a foreign principal supplies materials to a Chinese manufacturer and the finished goods are then exported to the foreign principal or other parties outside China under the instruction of the foreign principal. The foreign principal retains title to the materials and finished goods while those materials and goods are in the hands of the Chinese manufacturer. In this business model, the Chinese manufacturer would be considered as a business agent of the foreign principal, as the Chinese manufacturer is

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[33] Article 5 of the CIT Implementation Rules.

[34] Article 5 of the CIT Implementation Rules.

carrying out production and regularly storing goods in China on behalf of the foreign principal. Another example is a bonded warehousing arrangement. In such an arrangement, a foreign company will enter into a warehousing agreement with a Chinese warehousing company under which the foreign company has its goods delivered to a bonded warehouse operated by the Chinese warehousing company. The Chinese warehousing company will deliver the goods to the foreign company's customers upon the instructions of the foreign company. Some vendor-managed inventory arrangements are also similar to the warehousing arrangements. Because the Chinese warehousing company stores and delivers the goods of the foreign company, the Chinese warehousing company will be considered as a business agent of the foreign company. The Chinese tax authorities have, in practice, refrained from strictly enforced the rules and imposing tax on the foreign companies in these types of arrangements. Nevertheless, multinational companies should structure transactions under a treaty protection as China tax treaties have a narrower definition of "permanent establishment" than does "establishment" as defined in the CIT Law and the CIT Implementation Rules.

2.2.1.2 Permanent Establishment under Tax Treaty

China has entered into income tax treaties with many countries. China has also entered into tax arrangements, similar to a tax treaty, with Hong Kong and Macau, respectively. The CIT Law clearly states that where the provisions of the CIT Law are inconsistent with the provisions of tax treaties, the tax treaties will prevail.[35] According to tax treaties, the business profit of a foreign enterprise from a treaty country generally will not be taxable in China unless the foreign enterprise has a permanent establishment in China and the business profit is derived from the permanent establishment.

A "permanent establishment" in China under China tax treaties is a fixed place of business through which the business of an enterprise of a treaty country is wholly or partly carried out, including (1) a place of management; (2) a branch; (3) an office; (4) a factory; (5) a workshop; and (6) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources. A permanent establishment also includes a building site, a construction, assembly or installation project, or supervisory activities in connection therewith, but only where such site, project or activities continue for a period of time as specified in a tax treaty, which is commonly six months. Furthermore, the permanent establishment includes the furnishing of services, including consultancy services, by a foreign enterprise through employees or other personnel engaged by the foreign enterprise for such purpose, but only where such activities continue within China for a certain period of time. Most treaties provide a period or periods aggregating more than six months within any twelve-month period.

[35] Article 58 of the CIT Law.

The tax treaties usually exclude the following activities from permanent establishment:

(a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the foreign enterprise;
(b) the maintenance of a stock of goods or merchandise belonging to the foreign enterprise solely for the purpose of storage, display or delivery;
(c) the maintenance of a stock of goods or merchandise belonging to the foreign enterprise solely for the purpose of processing by another enterprise;
(d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the foreign enterprise;
(e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the foreign enterprise, any other activity of a preparatory or auxiliary character;
(f) the maintenance of a fixed place of business solely for any combination of the activities mentioned in sub-paragraphs (a) through (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

Where a person, other than an independent agent, is acting on behalf of a foreign enterprise from a treaty country and has and habitually exercises in China an authority to conclude contracts in the name of the foreign enterprise, that foreign enterprise will be deemed to have a permanent establishment in China in respect of any activities which that person undertakes for the foreign enterprise, unless the activities of such person are limited to those mentioned in (a)–(f) above.

An enterprise of a treaty country will not be deemed to have a permanent establishment in China merely because it carries on business in China through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, he will not be considered an agent of an independent status in determining the permanent establishment of the foreign enterprise in China if it is shown that the transactions between the agent and the foreign enterprise were not made under arm's-length conditions.

The business models mentioned in 2.2.1.1 technically would constitute an establishment or place of business in China and therefore subject the foreign enterprise to CIT. If the foreign enterprise is from a treaty country, the application of applicable tax treaty may relieve the foreign enterprise from CIT. For example, in the contract processing arrangement as mentioned in 2.2.1.1, the foreign principal would be considered maintaining a stock of goods or merchandise in China solely for the purpose of processing by another enterprise and, therefore, should not be deemed to have a permanent establishment in China. Similarly, in the example of bonded warehousing arrangement mentioned in 2.2.1.1, the Chinese warehousing company most likely will be considered as

an independent agent of the foreign enterprise. As such, receiving, storing, and delivering goods on behalf of the foreign enterprise should not constitute a permanent establishment of the foreign enterprise in China.

2.2.1.3 Production Sharing Contract between Chinese and Foreign Enterprises for Oil and Gas Projects

Foreign enterprises are allowed to participate in oil and nature gas exploration and development cooperation projects in China. The Chinese and foreign partners of oil and natural gas exploration and development cooperation projects must enter into production sharing contracts. Three China State-owned enterprises are granted exclusive right to negotiate, sign, and execute production-sharing contracts with foreign participants. Of the three Chinese enterprises, China National Petroleum Corporation and China Petroleum and Chemical Corporation are authorized to engage in onshore cooperation projects;[36] China National Offshore Oil Corporation is authorized to engage in offshore cooperation projects.[37] The enterprises that have signed the production-sharing contracts should, on their own expenses, conduct prospecting and exploration operations and undertake all prospecting risks. Both the foreign contractor and the Chinese participant shall, after an oil or natural gas field of commercial exploitation value is discovered, invest for cooperative exploitation.[38] The foreign contractor and the Chinese participant will share the profit or products. The foreign enterprise participating in oil and gas exploration will be treated as having a permanent establishment by virtue of the production-sharing contract in China. The foreign enterprise should be treated as a non-resident enterprise carrying on business in China and therefore should be subject to the CIT on the profits derived from production sharing contracts.

2.2.2 FOREIGN COMPANY RECEIVING INCOME FROM CHINA THAT IS NOT CONNECTED WITH ESTABLISHMENT IN CHINA

A non-resident enterprise that does not have any establishment or place of business in China or that has an establishment or place of business in China but whose income is not

[36] Article 6 of the Regulations of the PRC Concerning Chinese-foreign Cooperation in Exploiting Continental Petroleum Resources, promulgated by Order No.131 of the State Council on October 7, 1993, revised by the State Council by on September 23, 2001 and Order No. 506 of the State Council on September 18, 2007.

[37] Article 6 of the Regulations of the PRC Concerning Chinese-foreign Cooperation in Exploiting Offshore Petroleum Resources, promulgated by the State Council on January 30, 1982 and revised by the State Council on September 23, 2001.

[38] Article 13 of the Regulations of the PRC Concerning Chinese-foreign Cooperation in Exploiting Continental Petroleum Resources; Article 8 of the Regulations of the PRC Concerning Chinese-foreign Cooperation in Exploiting Offshore Petroleum Resources.

effectively connected with such establishment or place of business, shall pay CIT on its PRC-sourced income.[39] According to the CIT Implementation Rules, "income from sources within and outside the PRC" shall be determined according to the following principles:[40]

(1) For income from the sales of goods, the source shall be the place where the transactions take place;
(2) For income from the provision of services, the source shall be the place where services are provided;
(3) For income from the transfer of properties, in the case of immovable properties, the source shall be the place where the property is located; in the case of movable properties, the source shall be where the enterprise, establishment or place of business that transfers the property is located; and in the case of equity investments, the source shall be where the invested enterprise is located;
(4) For income from dividends, profit distributions, and other returns on equity investments, the source shall be the place where the enterprise making the distributions is located;
(5) For interest income, rental income, and royalty income, the source shall be the place where the enterprise, establishment, or place of business that bears or pays the income is located; or the place of residence of the individual who bears or pays the income; and
(6) For other income, the source shall be determined by the departments of the State Council in charge of finance and taxation.

According to the above income source rules, the income of a non-resident enterprise that is not effectively connected with an establishment or place of business in China typically will include dividends paid by an entity in China, interest paid by a borrower in China, rent paid by a lessee in China, royalties paid by an licensee in China, gains on transfers of immovable property located in China, and gains on transfer of equity in a Chinese enterprise.

2.2.3 REPRESENTATIVE OFFICE OF FOREIGN ENTERPRISE

Foreign enterprises are permitted to set up representative offices in China. China representative offices of foreign enterprises must be registered with the Chinese government authorities. Those representative offices generally are in the nature of liaison offices and have a limited scope of business. According to administrative regulations, a representative

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[39] Article 3 of the CIT Law.

[40] Article 7 of the CIT Implementation Rules.

office of a foreign enterprise may engage in (1) the activities of market surveys, exhibition, and promotion in relation to the products and services of the foreign enterprise and (2) liaision activities in relation to product sale, provsion of services, procurement within China, and investment within China by the foreign enterprise.[41]

2.2.3.1 Prior to 2010

Before July 1, 2003, most representative offices were taxable. According to Guo Shui Fa [1996] No.165,[42] a representative office is exempted from tax if the representative office merely engages in gathering the information of Chinese market, providing business information, liaison and other preparatory or auxiliary activities for the production and sales of the products of the headquarters of the representative office. Such tax-exempted activities do not include similar or relevant activities provided by a representative office for the agency or service business of its headquarters. The circular lists various taxable activities. In practice, the tax authorities gave tax-exemption status to the representative offices that are directly owned by a manufacturing company. Most other representative offices were taxed based on the expenses of the representative offices, which is often referred as the cost-plus method.

On March 12, 2003, the SAT reinterpreted and clarified tax methods for representative offices in Guo Shui Fa [2003] No. 28.[43] The tax circular confirmed the non-taxable status for the representative offices of manufacturing enterprises for liaison activities and tax exemption status for representative office of nonprofit organizations. Other representative offices are classified into three categories based on different tax reporting methods:

(1) Actual profit method. This method is applicable to representative offices of law firms, accounting firms, and consulting firms that provide services in China. Those are special types of representative offices that are licensed to conduct limited revenue-generating services. Those representative offices are taxed like a corporation and taxed on the net profits of representative offices.

[41] Article 14 of Measures on Administration of Registrartion of Representative Offices of Foregin Enterprises, State Council Order No. 584, issued by the State Council on November 19, 2010 and effective on March 1, 2011. However, Article 4 of the Detailed Implementing Rules Governing the Examination, Approval and Administration of Representative Offices of Foreign Enterprises, Order of Ministry of Foreign Trade and Economic Cooperation [1995] No. 3, issued by of the former Ministry of Foreign Trade and Economic Cooperation on February 13, 1995, provides that a representative office may engage in indirect business operations within China, to represent its enterprise in conducting business liaison, product introduction, market surveys and research, and technological exchange within the scope of business of that enterprise.

[42] Notice on the Relevant Issues Concerning the Strengthening of the Collection and Management of the Taxes of the Representative Offices of Foreign Enterprises, Guo Shui Fa [1996] No.165, issued by the SAT on September 13, 1996.

[43] The Notice on the Relevant Issues Concerning Tax Administration of the Representative Offices of Foreign Enterprises, Guo Shui Fa [2003] No. 28, issued by the SAT on March 12, 2003.

(2) The cost-plus method. Under the tax circular, the cost-plus method applies to (a) the commodity trading activities carried out by the representative offices set up by a foreign company engaged in trading business; (b) contract or agency-based advertising works undertaken by representative offices set up by advertising companies; and (c) service activities undertaken on behalf of clients by representative offices set up by travel companies. The tax authorities deem which representative offices provide those services. As such the determination of the tax method is based on the nature of the headquarters and not on the actual activities undertaken by the representative offices themselves.

(3) Default category. This category covers all taxable representative offices that are not listed in (1) and (2) above. Those representative offices should report tax based on actual revenue derived from their business activities, including the revenue received by the head offices of representative offices.

In 2003, the representative offices established prior to July 1, 2003 were given an opportunity to provide a self-assessment on the classification of tax reporting method in accordance with Guo Shui Fa [2003] No. 28. Many representative offices then existed changed the tax filing method from the cost-plus to the default category. Most of those reclassified representative offices took a position that they do not have actual revenue and therefore do not need to pay the CIT.

2.2.3.2 Current Regulations

In February 2010, the SAT issued the Provisional Measures on Administration of Tax Collection of Foreign Representative Offices.[44] According to the new tax circular, a foreign representative office is required to set up accounting books and accurately calculate its taxable revenue and taxable income based on the matching principle of its functions and risks.[45] If a foreign representative office cannot correctly compute its revenue, cost, or expenses, or cannot file tax returns using the actual profit-based method due to insufficient books and records, the tax authority may determine the taxable income of the foreign representative office using a cost-plus method or a gross income-based method.[46] For more discussions of those deemed methods, please see Chapter 3.3.3.

Prior to 2010, representative offices of foreign governments, international organizations, and foreign nonprofit organizations were exempted from the CIT. The establishment of those representative offices in China required the approval of relevant Chinese government authority. Prior to 2008, the authority to approve the tax exemption status was held by the SAT. The tax bureau in charge was required to forward the application

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[44] Guo Shui Fa [2010] No. 18, issued by the SAT on February 20, 2010 and effective from January 1, 2010.

[45] Article 6 of Guo Shui Fa [2010] No. 18.

[46] Article 7 of Guo Shui Fa [2010] No. 18.

level by level to the SAT for a final approval.[47] In 2008, the SAT issued Guo Shui Han [2008] No. 945 and delegated the approval authority to the state tax bureaus in provinces, autonomous regions, municipalities directly under the Central Government, and the cities specifically designated in the state plan.[48]

Guo Shui Fa [2010] No. 18 abolished Guo Shui Fa [1996] No. 165, Guo Shui Fa [2003] No. 28, and Guo Shui Han [2008] No. 945. Local tax authorities will no longer accept the applications of foreign representative offices for CIT exemption; the tax authorities are required to "clean up" the representative offices that obtained CIT exemption approvals prior to the issuance of Guo Sui Fa [2010] No. 18.[49]

According to China double income tax treaties, China cannot impose CIT on the offices of foreign enterprises solely for the purpose of carrying on activities of a preparatory or auxiliary character. Technically, a representative office of a foreign company that conducts only preparatory or auxiliary activities can claim exemption of CIT based on the position that the activities of the office do not constitute a permanent establishment of the foreign company in China. It is not clear how the tax treatment under Guo Shui Fa [2010] No. 18 will be reconciled with the provisions of double income tax treaties.

The China representative offices of foreign airlines are in a special category of foreign representative offices. To establish a representative office in China by foreign airlines, the foreign airlines must obtain approval from the Civil Aviation Administration of China.[50] The representative offices of foreign airlines often are authorized to sell tickets for designated routes to customers in China either directly or through travel agents. Those representative offices are permitted to collect the proceeds from ticket sales and remit those proceeds to head offices of the foreign airlines. Although those representative offices are taxable (i.e., the establishment or place of business of non-resident enterprises) according to the general rule of China domestic tax law and regulations, they typically are exempted from CIT under applicable shipping and air transportation provision of double income taxation agreements or applicable air transportation agreements between China and foreign countries or regions.

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[47] Guo Shui Fa [2003] No. 28.

[48] The Notice on Relevant Issues Concerning the Examination and Approval Procedure for Tax Exemption on the Representative Offices Established by Foreign Governments and Other Organizations within China, Guo Shui Han [2008] No. 945, issued by the SAT on November 21, 2008.

[49] Article 11 of Guo Shui Fa [2010] No. 18.

[50] Administrative Measures for the Examination and Approval of Representative Offices of Foreign Air-transport Enterprises, Order of Civil Aviation Administration of China [2006] No. 165, issued by Civil Aviation Administration of China on April 3, 2006.

3

TAX BASE AND RATE

3.1 General

A resident enterprise shall pay CIT on its income from sources within and outside the PRC. A non-resident enterprise with an establishment or place of business in China shall pay CIT on its PRC-sourced income derived by such establishment or place of business and on its foreign-sourced income that is effectively connected with such establishment or place of business.[1] The taxable income of an enterprise in a tax year shall be its total revenue for the tax year less its non-taxable revenue, tax-exempted revenue, various deductions and the allowable losses carried forward from prior years.[2] Taxable income is computed based on accounting profits before income tax and adjusted in accordance with tax law and regulations. The profit-based tax base applies to both resident enterprises and the non-resident enterprises that derive income from an establishment or place of business in China with certain exceptions discussed in Chapter 3.3.

The CIT rate on and after January 1, 2008 is 25 percent.[3] This flat rate is applicable to resident enterprises as well as the non-resident enterprises that derive income from an

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[1] Article 3 of the CIT Law.

[2] Article 5 of the CIT Law.

[3] Article 4 of the CIT Law.

establishment or place of business in China. However, tax exemption and reduced rates are granted as part of tax incentives.

3.2 Small Scale Enterprises with Low Profitability

A reduced CIT rate at 20 percent is applicable to qualified small-scale enterprises with low profitability.[4] Qualified small-scale enterprises with low profitability are enterprises that are not engaged in industries restricted or prohibited by the State and that meet all of the following conditions:[5]

(1) For industrial enterprises, the taxable income for the year shall not exceed RMB300,000, total employees shall not exceed 100, and total assets shall not exceed RMB 30 million;
(2) For all other enterprises, the taxable income for the year shall not exceed RMB300,000, total employees shall not exceed 80, and total assets shall not exceed RMB 10 million.

The reduced CIT rate for small-scale enterprises with low profitability only applies to Chinese resident enterprises and does not apply to non-resident enterprises.[6] As such, foreign enterprises that have an establishment or place of business in China will be taxed at 25 percent regardless of the amount of taxable income and number of employees.

As a temporary policy to support the development of small- and mid-sized enterprises during the global financial crisis, the State Council approved an additional reduction in the tax rate for some small-scale enterprises with low profitability. If an enterprise that is qualified as a small-scale enterprise with low profitability as discussed above and its taxable income is RMB30,000 or less, the taxable income is computed at 50 percent of its actual income. This policy actually reduces the CIT rate to 10 percent. This is a one-year policy for the period from January 1, 2010 to December 31, 2010.[7]

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[4] Article 28 of the CIT Law.

[5] Article 92 of the CIT Implementation Rules.

[6] The Notice on the Issue of Exclusion of Non-resident Enterprises from the Application of Preferential Corporate Income Tax Policies for Small-scale Enterprises with Low Profitability, Guo Shui Han [2008] No. 650, issued by the SAT on July 3, 2008.

[7] The Notice on the Corporate Income Tax Policy Concerning Small Scale Enterprises with Low Profitability, Cai Shui [2009] No. 133, issued by the MOF and the SAT on December 2, 2009 and effective from January 1, 2010 to December 31, 2010.

3.3 Deemed Profit Rate and Deemed CIT

3.3.1 RESIDENT ENTERPRISE

A resident enterprise may be required to pay CIT based on a deemed basis, rather than computed based on actual taxable income. The assessment of CIT on a deemed basis is applicable to taxpayers in any of the following circumstances:[8]

(1) The taxpayer is allowed not to set up accounting books in accordance with laws and administrative regulations;
(2) The taxpayer has not yet set up accounting books, although those should have been set up in accordance with laws and administrative regulations;
(3) The taxpayer has destroyed accounting books without proper authorization or refused to provide the information in relation to taxation;
(4) The taxpayer has not maintained sufficient accounting books and records that are sufficient for the tax authorities to verify the accounts;
(5) The taxpayer failed to file a tax return within the prescribed time after its tax liability had occurred and has not filed the return, within the prescribed time limit, after the order for rectification by the taxation authority; and
(6) The tax calculation basis filed is obviously low without proper reasons.

The deemed basis method, however, does not apply to the following enterprises:[9]

(1) Enterprises that enjoy one or more CIT incentive polices as provided in the CIT Law, the CIT Implementation Rules, and by the State Council except for the tax exemptions of interest from state treasury debts and qualified inter-company dividends;
(2) Enterprises that file consolidated returns of group enterprises;
(3) Listed companies;
(4) Financial enterprises such as banks, credit institutions, small loan companies, insurance companies, securities companies, futures companies, trust and investment companies, financial assets management companies, finance leasing companies, guarantee companies, finance companies, and pawn companies;
(5) Institutions in the businesses of intermediaries services such as accounting, auditing, assess appraisal, tax, real estate appraisal, land appraisal, engineering

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[8] Article 3 of the Measures on Assessment of Corporate Income Tax on a Deemed Basis (Trial Implementation), Guo Shui Fa [2008] No. 30, issued by the SAT on March 6, 2008 and effective on January 1, 2008.

[9] Article 3 of Guo Shui Fa [2008] No. 30; Article 1 of the Notice on Certain Issues Concerning the Assessment of Corporate Income Tax on a Deemed Basis, Guo Shui Han [2009] No. 377, issued by the SAT on July 14, 2009 and effective on January 1, 2009.

cost consulting, legal services, price certification services, notary public, patent agency, trademark agency, and other economic certification services; and
(6) The other enterprises as prescribed by the SAT.

There are two methods to assess CIT on a deemed basis. One is to calculate CIT based on a deemed profit rate; another is to assess amount of CIT directly. The tax authorities may apply the deemed profit rate method to a taxpayer in the following circumstances:

(1) The total revenue of the taxpayer can be correctly verified but the total cost and expenses cannot be verified;
(2) The total cost of the taxpayer can be correctly verified, but the total income cannot be verified; or
(3) The total income or total cost can be calculated and estimated through rational methods

For taxpayers that do not meet one of the above conditions, the tax authorities should directly assess the amount of CIT liability.[10] The tax authorities may assess CIT liability based on:

(1) The tax burden level of taxpayers with similar operating scale and income level in the same industry or similar industry locally;
(2) The total income subject to tax or cost;
(3) The raw materials, fuels and powers that have been consumed; and
(4) Other rational methods.

If the adoption of any of the above methods is unable to accurately derive taxable income or tax payable amounts, two or more methods may be used concurrently. If the tax payable amounts estimated by two or more methods are inconsistent, the higher payable amount shall be selected.[11]

If the deemed profit rate method is used, the following formula should apply:[12]

Tax payable = Taxable income × Applicable tax rate

Taxable income = Taxable revenue × Deemed profit rate

[10] Article 4 of Guo Shui Fa [2008] No. 30.
[11] Article 5 of Guo Shui Fa [2008] No. 30.
[12] Article 6 of Guo Shui Fa [2008] No. 30.

$$\text{Taxable revenue} = \text{Gross revenue} - \text{Non-taxable income} - \text{Exempted income}$$[13]

Or

$$\text{Taxable income} = \text{Totalcost}/(1 - \text{Applicable tax rate}) \times \text{Deemed profit rate}$$

The deemed profit rate is determined by the tax authorities based on the following ranges in the table below:[14]

Industry	Deemed profit rate (%)
Agriculture, Forestry, Husbandry and Fishery	3–10
Manufacturing	5–15
Wholesaling and Retailing	4–15
Transportation	7–15
Construction	8–20
Food and Beverage	8–25
Entertainment	15–30
Others	10–30

In order to collect CIT on a deemed basis, the tax authority in charge of the taxpayer should deliver to the taxpayer the Assessment Form for Collection of Corporate Income Tax on Deemed Basis. The taxpayer should complete the form and submit it to the tax authority within ten days after receiving the form. The tax authority shall, within twenty working days of acceptance of the assessment form, examine and verify it by categories and accounts, issue an assessment opinion, and report to the county level tax authority for review and approval, which should be made within thirty working days.[15] Once a deemed profit rate or fixed CIT payable is determined, such rate or amount generally should apply for the tax year. Where there is a significant change to the business scope or the major business of the taxpayer, or the taxable income or tax payable of the enterprise increases or decrease 20 percent or more, the taxpayer shall report in a timely manner to the tax authorities to adjust the determined tax payable or deemed profit rate.[16] The status of a taxpayer paying CIT on a deemed basis should be assessed on an annual basis. If a taxpayer is paying CIT on a deemed basis in previous year, the tax authorities shall re-assess the taxpayer's status before June 30 of the current year. Prior to the completion

[13] Article 2 of Guo Shui Han [2009] No. 377.

[14] Article 8 of Guo Shui Fa [2008] No. 30.

[15] Article 10 of Guo Shui Fa [2008] No. 30.

[16] Article 9 of Guo Shui Fa [2008] No. 30.

of re-assessment, the taxpayer may make provisional tax payment in accordance with the method adopted for the previous year. Upon the completion of re-assessment, adjustment, if any, shall be made in accordance with the re-assessment result.[17]

Example: Application of Deemed Profit Rate

Happy Retail Limited pays CIT using deemed profit rate method. The deemed profit rate determined by the tax authority in charge is 10 percent. Happy Retail Limited had annual revenue of RMB500,000 in 2008. Its CIT for 2008 should be computed as follows:

Taxable income = RMB500,000 x Deemed profit rate 10% = RMB50,000.

CIT = RMB50,000 x Tax rate 25% = RMB12,500.

3.3.2 NON-RESIDENT ENTERPRISE WITH ESTABLISHMENT IN CHINA

As discussed in 2.2.1, if a non-resident enterprise has an establishment or place of business in China, the non-resident enterprise is subject to China tax on its income from China and overseas that is effectively connected to the establishment or place of business in China. Similarly, if the foreign enterprise of a treaty country with China has a permanent establishment in China under the double taxation treaty, the foreign enterprise should be subject to CIT on its profits derived from the permanent establishment. The establishment or permanent establishment of a foreign enterprise is taxed in a way similar to a resident enterprise. A regular tax rate of 25 percent should apply to taxable income, which is computed by taxable revenue less allowable expenses.

For computing CIT taxable income of a non-resident enterprise in connection with an establishment or place of business in China on an actual profit basis, the non-resident enterprise must maintain accurate and complete accounts to determine the actual profits arising from the establishments in China. If a non-resident enterprise is unable to correctly compute taxable income due to inaccurate or incomplete accounts or other reasons, the Chinese tax authorities will assess the taxable income using a deemed profit method. These non-resident enterprise contracts include construction, engineering supervision, installation, consulting, technical services, and others. The MOF and the SAT issued several circulars concerning deemed profit rates for non-resident enterprises under the FEIT Law regime. In practice, the tax authorities determined the deemed profit rate at a range of 10 to 40 percent of revenue or deemed revenue on a case-by-case basis prior to February 20, 2010.

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[17] Article 11 of Guo Shui Fa [2008] No. 30.

In February 2010, the SAT issued a tax circular addressing the calculation of CIT for a non-resident enterprise on a deemed profit basis.[18] According to the tax circular, if a non-resident enterprise is unable to correctly compute taxable income due to inaccurate or incomplete accounts or other reasons, the Chinese tax authorities shall assess the taxable income using one of the following "deemed profit methods":[19]

(1) Actual revenue and deemed profit method. This method is applicable where revenue can be ascertained but costs and expenditures cannot. Under this method, the taxable income is computed using the following formula:

$$\text{Taxable income} = \text{Revenue} \times \text{Deemed profit rate}$$

(2) Cost-plus method. This method is applicable where revenue cannot be ascertained but costs can be. Under this method, the taxable income is computed using the following formula:

$$\text{Taxable income} = \text{Cost} \div (1 - \text{Deemed profit rate}) \times \text{Deemed profit rate}$$

(3) Expenditure-plus method. This method is applicable where revenue and costs cannot be ascertained but expenditures can be. Under this method, the taxable income is computed using the following formula:

$$\text{Taxable income} = \text{Expenditures} \div (1 - \text{Deemed profit rate} - \text{Business Tax rate}) \times \text{Deemed profit rate}$$

On and after December 1, 2010, foreign enterprises are subject to City Maintenance and Construction Tax and Eduction Surchage.[20] The tax base of City Maintenance and Construction Tax and Education Surcharge is the amount of VAT, Business Tax, and Consumption Tax paid. As such, when a non-resident pays Buinsss Tax on and after December 1, 2010, it should also pay City Maintenance and Construction Tax and Education Surcharge at the same time. It is not clear, however, whether City Maintenance and Construction Tax and Education Surcharge will be added to Business Tax in computing taxable income under the expenditure-plus method. As City Maintenance and

[18] The Administrative Measures for the Collection of Corporate Income Tax on Non-resident Enterprises on a Deemed Basis, Guo Shui Fa [2010] No. 19, issued by the SAT on February 20, 2010 and effective on February 20, 2010.

[19] Article 4 of Guo Shui Fa [2010] No. 19.

[20] The Notice on Unification of City Maintenance and Construction Tax and Education Surcharge for Domestic Enterprises, Foreign Invested Enterprises, and Foreign Individuals, Guo Fa (2010) No. 35, issued by the State Council on October 18, 2010 and effective from December 1, 2010.

Construction Tax and Education Surcharge are different taxes from Business Tax, if the expenditure-plus method formla above needs to be adjustment to include City Maintenance and Construction Tax and Education Surcharge, the MOF and/or the SAT should issue a tax circular to clarify.

The "deemed profit rate" used in the above formulas is determined by the tax authorities, based on the business of non-resident enterprises. For engineering and construction projects, design services, and consulting services, the deemed profit rate is in the range of 15 to 30 percent. For management services, the deemed profit rate is in the range of 30 to 50 percent. For other services and business activities, the deemed profit rate should not be lower than 15 percent. Furthermore, if the tax authorities have evidence to believe that the actual profit rate of a non-resident enterprise is significantly higher than the above range, the tax authorities can determine a deemed profit rate higher than the standard range as provided above.[21] Where a non-resident enterprise carries on multiple business activities in different deemed profit rates, the non-resident enterprise should compute its CIT on income in different businesses using applicable deemed profit rates respectively. If the enterprise is unable to separately compute its income in different businesses, the highest deemed profit rate among the rates applicable to the businesses should be used in computing its CIT.[22]

Where a non-resident enterprise sells equipment and at the same time provides services, such as installation, technical training, and supervision, in China, the Chinese tax authorities may assess the service income by reference to pricing standard in the same or similar service sector in cases where the service fee is not specified in the sales contract or not charged on a reasonable basis. Where reference is not available, the tax bureau may apportion the contract amount to be the service income and the proportion shall not be less than 10 percent of the total contract amount.[23]

Where a non-resident provides services to a customer in China, if all services are performed in China, the full amount of income should be subject to CIT; if services are performed both within China and outside China, the income should be allocated based on the place of services. Where the Chinese tax bureau casts doubt on the reasonableness and truthfulness of the onshore and offshore service income allocation, it can request the non-resident enterprises to provide evidence to substantiate the allocation. The tax bureaus may re-allocate the onshore and offshore service income by reference to work volume, time, cost, and other relevant factors. If a non-resident enterprise is not able to provide the evidence to support its allocation, the entire service income may be deemed as onshore service income and subject to CIT.[24]

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[21] Article 5 of Guo Shui Fa [2010] No. 19.

[22] Article 8 of Guo Shui Fa [2010] No. 19.

[23] Article 6 of Guo Shui Fa [2010] No. 19.

[24] Article 7 of Guo Shui Fa [2010] No. 19.

3.3.3 FOREIGN REPRESENTATIVE OFFICE

As discussed in 2.2.3, taxable representative offices of foreign enterprises are classified into three categories based on different tax reporting methods: actual profit method, cost-plus method, and actual revenue and deemed profit method.

3.3.3.1 Actual Profit Method

As a general rule as provided in Guo Shui Fa [2010] No. 18, a representative office should set up and maintain books and records and accurately compute its taxable revenue and taxable income based on the matching principle of its functions and risks.[25] However, unless a representative office is licensed to conduct direct business generating activities and collect revenues, it would be difficult for a representative office to accurately compute its actual revenue and taxable income. Prior to the issuance of Guo Shui Fa [2010] No. 18, this actual profit method was only applicable to limited types of representative offices such as representative offices of foreign law firms because those typically are allowed to conduct revenue-generating services and collect revenue. It is not clear whether a representative office can adopt the actual profit method and claim zero revenue and an actual loss. A representative office that reports tax on the actual profit method is taxed like a corporation. A 25 percent CIT will apply to taxable income of the representative office.

3.3.3.2 Cost-Plus Method

A cost-plus method will apply to a representative office that can correctly compute its operating expenses but cannot accurately calculate its revenue or costs and expenses. Under the cost-plus method, the following formulas are used to derive gross income and CIT:[26]

$$\text{Deemed revenue} = \text{Operating expenses} \div \left(1 - \text{Deemed profit rate} - \text{Business Tax rate}\right)$$

$$\text{CIT} = \text{Deemed revenue} \times \text{Deemed profit rate} \times 25\%$$

The operating expenses of a representative office include:

(1) Salaries and wages, bonuses, allowances, and benefits paid inside and outside China to the personnel of the representative office;
(2) Rental payments for immovable property and equipment;

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[25] Article 6 of Guo Shui Fa [2010] No. 18.

[26] Article 7(1) of Guo Shui Fa [2010] No. 18.

(3) The acquisition cost of fixed assets such as automobiles and office equipment and other office supplies. The cost of a fixed asset is treated as a one-time operating expense at the time of acquisition;
(4) The cost of leasehold improvement, which is also treated as a one-time operating expense;
(5) Expenses for telecommunication, transportation, travel, and entertainment. Unlike other taxpayers whose deduction of business entertainment expenses is subject to limitation, a representative office using the cost-plus method is required to include the full amount of entertainment in its operating expenses;
(6) Other expenses, which include, for example, sample costs and transportation costs paid for samples purchased in China on behalf of the head office, warehouse charges and customs fees incurred in China in respect of overseas samples shipped to China, fees for translators engaged by the head office's personnel visiting China, and charges of purchasing tender documents paid by the representative office for a specific project in China.

In computing operating expenses, interest income cannot be offset against the expenses. The expenses arising from activities not belonging to its own business, such as money used for public charity within the country; donations of a relief nature; and late fees, fines and payments on behalf of the head office shall not be taken as the operating expenses of a representative office.

The deemed profit rate was 10 percent prior to January 1, 2010. On and after January 1, 2010, the deemed profit rate should not be lower than 15 percent.[27] Business Tax is a turnover tax on certain services. Business Tax rate on service fees for a representative office currently is 5 percent. Applying the cost-plus formulas, the effective tax rate is:

$$\text{Deemed revenue} = \text{Operating expenses} \div (1 - 15\% - 5\%) = \text{Operating expenses} \div 80\%$$

$$\text{CIT} = \text{Deemed revenue} \times 15\% \times 25\% = 4.6875\% \text{ of Operating expenses}$$

$$\text{Business Tax} = \text{Deemed revenue} \times 5\% = 6.25\% \text{ of Operating expenses}$$

As shown above, the combined Business Tax and CIT rate is 10.9375 percent of operating expenses on and after January 1, 2010.

An example is shown in the table below, in which the operating costs are assumed to be RMB1 million.

27 Article 8 of Guo Shui Fa [2010] No. 18.

Deemed revenue	RMB1,250,000
Business Tax at 5%	RMB62,500
Deemed 15% profit on RMB1,250,000	RMB187,500
CIT at 25%	RMB46,875
Total of CIT and Business Tax	RMB109,375

As discussed in Chapter 3.3.2, on and after December 1, 2010, foreign enterprises are subject to City Maintenance and Construction Tax and Eduction Surchage. In addition to paying 5 percent Business Tax, a representative office should pay 0.5 percent City Maintenance and Construction Tax and Eduction Surchage at time of paying Business Tax on and after December 1, 2010. The above formula and example have not reflect the pssoible adjustment due to the newly applicable taxes.

3.3.3.3 Actual Revenue and Deemed Profit Method

The actual revenue and deemed profit method is applicable to a representative office which is able to accurately report its revenue but not able to accurately report the costs. Under this method, the following formula is used to derive CIT:[28]

CIT = Total revenue × Deemed profit rate × CIT rate

As most representative offices are act as liaisons and are not permitted to conduct direct revenue generating activities or collect revenue, it would be conceptually difficult to ascertain the actual revenue of those representative offices. In practice, such "actual revenue" is often based on a service agreement between the foreign company owing the representative office and an affiliated foreign company. For example, Foreign Company A sets up a representative office in China. The representative office provides liaison and business promotion services to A's sister company B. A and B may enter into a service agreement for the services performed by the representative office. The service fee provided in such inter-company service agreement is considered the actual revenue of the representative office.

Many representative offices were classified in the default category under Guo Shui Fa [2003] No. 28. Many of those representative offices claimed no revenue and therefore do not pay CIT. As Guo Shui Fa [2003] No. 28 has been repealed by Guo Shui Fa [2010] No. 18, it is questionable whether those representative offices can continue to claim no revenue under the actual revenue and deemed profit method. It appears that the tax authorities in many locations try to push representative offices into the cost-plus method.

[28] Article 7(2) of Guo Shui Fa [2010] No. 18.

Tax authorities in some locations have requested that representative offices change their filing method to the cost-plus method if the representative offices have no revenue. On the other hand, the tax authorities in some locations have not actively pushed those representative offices to a tax paying entity status.

3.4 Non-Resident Enterprise without Establishment in China

If a non-resident enterprise derives PRC-sourced income that is not effectively connected with an establishment or place of business in the PRC, the enterprise is liable for CIT on the PRC-sourced income.[29] The CIT rate applicable to such PRC-sourced income is 20 percent under the CIT Law.[30] The CIT Law, however, lists this category of income as one that is eligible for exemption from or reduction of CIT.[31] The State Council is authorized to issue detailed measures for the preferential tax treatment.[32] The applicable CIT rate is reduced to 10 percent in accordance with the CIT Implementation Rules issued by the State Council.[33] The income in this category typically includes dividends, interest, royalties, rent or leasing income, and gain on transfer of properties. The tax base or taxable income for dividends, interest, royalties, and rent or leasing income is gross revenue,[34] which is defined as the total consideration and other charges received by a non-resident from a payer.[35] The tax base for gains from transfer of properties is gross revenue less net property value.[36] Although "net property value" is not defined in the CIT Law and the CIT Implementation Rules, it should mean the tax basis in the property. The tax basis in the property should be the acquisition cost adjusted, if any, in accordance with tax law and regulations. The tax base for other income should be calculated with reference to the two methods (i.e., gross basis and net basis) mentioned above.[37] Other than the allowable deduction items listed in the tax law and regulations (i.e., net property value in computing gain on transfer of properties), no expenses and taxes can be deducted in computing taxable income for non-resident enterprises not effectively connected with an establishment or a place of business in China.[38] In addition to CIT, a non-resident enterprise is subject to Business Tax on interest, rentals,

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[29] Article 3 of the CIT Law.

[30] Article 4 of the CIT Law.

[31] Article 27 of the CIT Law.

[32] Article 35 of the CIT Law.

[33] Article 91 of the CIT Implementation Rules.

[34] Article 19(1) of the CIT Law.

[35] Article 103 of the CIT Implementation Rules.

[36] Article 19(2) of the CIT Law.

[37] Article 19(3) of the CIT Law.

[38] The Notice on the Relevant Issue of Levying Corporate Income Tax on Non-resident Enterprises, Cai Shui [2008] No. 130, issued by the MOF and the SAT on September 25, 2008.

and royalties. Prior to January 1, 2008, Business Tax was deductible in computing taxable income for CIT under previous tax law and regulations. Under the CIT Law and the CIT Implementation Rules, such deduction of Business Tax is no longer allowed. The transaction expenses, such as broker fees and other professional fees, should also not be deductible.

4

INCOME

The taxable income of an enterprise in a tax year is its total revenue for the tax year less its non-taxable revenue, tax-exempt revenue, various deductions, and allowable losses brought forward from prior years.[1] The total revenue of an enterprise includes both the monetary revenues and non-monetary revenues.[2] The monetary revenues include cash, deposits, account receivable, notes receivable, bond investment to be held to maturity, and debt forgiven. The non-monetary revenue derived by an enterprise includes the fixed assets, the biology assets, intangible assets, equity investments, inventories, and bond investments not to be held to maturity, services, and other rights.[3] If an enterprise acquires non-monetary income, the recognition of such income should be calculated based on the fair value of the income item, which is the assets' value determined in accordance with the market price.[4] An enterprise derives it revenue from various sources. The CIT Law lists nine categories of income, including (1) the revenue from sale of goods, (2) the revenue from provision of services, (3) the revenue from transfer of property,

[1] Article 5 of the CIT Law.

[2] Article 6 of the CIT Law.

[3] Article 12 of the CIT Implementation Rules.

[4] Article 13 of the CIT Implementation Rules.

(4) dividends, profit distribution and other returns on equity investments, (5) interest income, (6) rental income, (7) royalties, (8) donations income; and (9) other revenue.[5]

The amount of taxable income of enterprise shall be computed on the accrual basis. For the income and expense belonging to the current period, regardless of whether they have received or paid, they shall be recognized as the income and expense in the current period; for the income and expense not belonging to the current period, even if they have received or paid in the current period, they shall not be recognized as the income and expense in the current period, unless otherwise prescribed in the CIT Implementation Rules and the circulars issued by competent finance and taxation departments under the State Council.[6]

4.1 Revenue from the Sale of Goods

The revenue from the sale of goods for CIT purposes means the income derived by an enterprise from the sale of merchandise, products, raw materials, packaging materials, low-value consumables, and other inventories.[7] When an enterprise sells goods, income shall be recognized if all the four conditions below are met:[8]

(1) The contract for the sales of goods has been concluded and the title to the goods and main risks and benefits of the goods have been passed to the buyer;
(2) The enterprise retains neither continuous management right that usually keeps relation with the ownership, nor effective control over the sold goods;
(3) The relevant amount of revenue can be measured in a reliable way; and
(4) The relevant costs incurred or to be incurred can be measured in a reliable way.

Where all the conditions for revenue recognition are met, the time for revenue recognition for the following transactions can be as follows:[9]

(1) Where the payment is made through documentary collection against acceptance, the revenue should be recognized when the enterprise submits the documents to its bank for collection;
(2) If the price of goods is prepaid, the revenue should be recognized upon shipping the goods to the buyer;

5 Article 6 of the CIT Law.

6 Article 9 of the CIT Implementation Rules.

7 Article 14 of the CIT Implementation Rules.

8 Article 1(1) of Notice on Certain Issues Concerning Revenue Recognition for Corporate Income Tax Purposes, Guo Shui Han [2008] No. 875, issued by the SAT on October 30, 2008.

9 Article 1(2) of Guo Shui Han [2008] No. 875.

(3) If the goods sold require installation and inspection, the revenue is recognized upon the buyer accept the goods and the installation and inspection are completed. If the installation is simple, the revenue can be recognized upon shipping the goods; and

(4) If the enterprise sells goods through consignment sales by paying commission, it recognizes the revenue when it receives a confirmation of sale from the consignee.

Where goods are sold and repurchased, the seller should recognize revenue on sale price; the repurchase is treated as a purchase transaction. However, if evidence shows that the sale of goods does not meet the revenue recognition conditions and the seller is to seek finance in the form of sale of goods, the proceeds received by the seller will be treated as a debt; the repurchase price in excess of selling price is treated as interest expense.[10]

If a sale is involved in trading in a used product in exchange for a new one, the seller of new product should recognize actual price of the new product sale as revenue; the returning or delivery of used product by the new product buyer is treated as a purchase by the new product seller.[11] A trade discount is a discount on the listed price granted by an enterprise for the purpose of sales promotion of goods. The enterprise should recognize the sale price net of trade discount as revenue. A cash discount is the amount of reduction of a debt offered by a creditor to a debtor for the purpose of encouraging the debtor to make payment within a prescribed time period. If an enterprise gives a cash discount to a customer, the enterprise must recognize the sale price without cash discount as revenue; the discount is treated as financial expense. If a customer returns goods sold by an enterprise as a result of the unqualified quality of the goods or inconformity with the required variety, or for other reasons, the enterprise should reduce revenue in the period when the sale of return occurs. Similarly, if a seller gives a discount as a result of the unqualified quality of the goods or inconformity with the required variety, the enterprise should reduce its revenue by the amount of discount at time the discount is given.[12] In a transaction where a customer buys one and gets one free or similar scheme, the free item is not treated as a donation. Rather, the total price should be allocated into each item based on the fair market value of each item.[13]

Where the sale of goods is on an installment basis, revenue shall be recognized on the date on which the payments become due under the contract. Further, where enterprises are engaged, under contract, to process or manufacture large-scale machinery and equipment, vessels, and aircraft and the duration of such processing or manufacturing

[10] Article 1(3) of Guo Shui Han [2008] No. 875.

[11] Article 1(4) of Guo Shui Han [2008] No. 875.

[12] Article 1(5) of Guo Shui Han [2008] No. 875.

[13] Article 3 of Guo Shui Han [2008] No. 875.

exceeds 12 months, the revenue shall be recognized based upon the rate of progress or the amount of work completed within the tax year.[14] Where revenue is derived under production sharing, revenue shall be recognized on the date on which the products are distributed to the participating enterprises, and the amount of revenue shall be determined based upon the fair value of the products.[15] In a barter trade where an enterprise exchanges goods for other goods and services, such exchange is treated as a sale of goods and then purchase of other goods and services; the enterprise shall recognize income on the sale. If an enterprise donates goods or uses goods for debt settlement, sponsorship, fund raising, advertisement, samples, staff welfare or profit distribution, the enterprise shall be deemed to sell the goods at fair market value.[16]

4.2 Revenue from the Provision of Services

The revenue from the provision of services refers to the revenue derived by an enterprise from engaging in construction and installation, repair, transportation, warehousing and leasing, finance and insurance, postal communications and telecommunications, consultancy and brokerage, culture and sports, scientific research, technical services, education and training, catering and accommodation, intermediary and agency, sanitation and health care, community services, tourism, entertainment, processing, and other service operations.[17] If an enterprise carries out construction, installation, or assembly projects, or provides other services the duration of which exceeds 12 months, revenue shall be recognized based upon the rate of progress or the amount of work completed within the tax year.[18]

If an enterprise can, at the end of a tax period, reliably estimate the outcome of a transaction concerning the services it provides, it shall recognize the revenue from providing services employing the percentage-of-completion method. The term "percentage-of-completion method" refers to a method to recognize the revenues and expenses in the light of the stage of completion under a transaction concerning the provision of services. For the outcome of a transaction concerning the provision of services to be measured in a reliable way, the following conditions shall be met simultaneously:[19]

(1) The amount of revenue can be measured in a reliable way;
(2) The schedule of completion under the transaction can be confirmed in a reliable way; and

[14] Article 23 of the CIT Implementation Rules.
[15] Article 24 of the CIT Implementation Rules.
[16] Article 25 of the CIT Implementation Rules.
[17] Article 15 of the CIT Implementation Rules.
[18] Article 23 of the CIT Implementation Rules.
[19] Article 2(1) of Guo Shui Han [2008] No. 875.

(3) The costs incurred or to be incurred in the transaction can be measured in a reliable way.

An enterprise may adopt the following methods to ascertain the schedule of completion under the transaction concerning the provision of services:[20]

(1) The measurement of the work completed;
(2) The proportion of services provided against the total services to be provided; and
(3) The proportion of the costs incurred against the estimated total costs.

An enterprise shall ascertain the total revenue from the provision of services in accordance with the total price for the services as stipulated in the contract. An enterprise shall, at the end of a tax period, recognize the income and cost from the provision of services for the current period using the following formula:[21]

$$\text{Current period income} = \text{Total revenue} \times \text{Schedule of completion} - \text{Accumulative revenues recognized in previous periods}$$

$$\text{Current period cost} = \text{Estimated total cost} \times \text{Schedule of completion} - \text{Accumulative costs recognized in previous periods}$$

The time of recognition of income for the provision of services depends on the nature of services and the relationship between the services and other transactions. An enterprise shall recognize income for the following services in accordance with the following conditions:[22]

(1) Installation service fees. Income shall be recognized based on the schedule of installation completion. However, if installation is part of commodity sale or a proviso to the sale of goods, the enterprise shall recognize the installation income at the time it recognizes income from the sale of goods.
(2) Advertising or media fees. The income should be recognized when the advertisement or other commercial action appears before the public. Advertising production revenue should be recognized based on the schedule of production completion.

[20] Article 2(2) of Guo Shui Han [2008] No. 875.
[21] Article 2(3) of Guo Shui Han [2008] No. 875.
[22] Article 2(4) of Guo Shui Han [2008] No. 875.

(3) Software fee. If an enterprise develops software for a specified customer, the enterprise shall recognize income based on the schedule of development completion;
(4) Service fee. Service fee that can be separated from the price for goods sold can be recognized during the service period;
(5) Fees for art performance, banquet services, and other special activities shall be recognized when the activity takes place. If the fees collected are for several activities, the prepaid fee shall be reasonably allocated to each item and recognized separately;
(6) Membership fee. If the fee is only for the admission to a membership and all services and goods will be charged to members when received, an enterprise shall recognize the full membership fee as income when received. If membership entitles members to receive services or goods without additional charges or at a price lower than that for non-members, the enterprise shall recognize the membership fee throughout the benefit period of the membership;
(7) Licensing fee. If the fee is for the supply of equipment or other tangible assets, income shall be recognized when the assets are delivered or title to the assets is transferred. If the fee is for service initially or subsequently provided, income shall be recognized when the services are provided; and
(8) Fee for routine services. If an enterprise receives a fee for the provision of repeat services to its customer for a long term, income shall be recognized when the relevant services are provided.

In a barter trade where an enterprise delivers services in exchanges for goods and other services, such exchange is treated as provision of services and then purchase of goods and other services; the enterprise shall recognize income on the provision of services. If an enterprise donates services or delivers services for debt settlement, sponsorship, fund raising, advertisement, samples, staff welfare or profit distribution, the enterprise shall be deemed to provide services at fair market value.[23]

4.3 Revenue from Transfer of Property

Revenue from the transfer of property refers to the revenue derived by an enterprise from the transfer of fixed assets, biological assets, intangible assets, equity interest, debt claims, etc.[24] The revenue from transfer of property normally is reported in the form of gain, which is the transfer proceeds less tax basis. The tax basis is the original acquisition cost

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[23] Article 25 of the CIT Implementation Rules.

[24] Article 16 of the CIT Implementation Rules.

or otherwise capitalized cost adjusted in depreciation or amortization, if any. There is no separate tax rate for capital gain. Gain derived from the transfer of property by an enterprise is included in the gross income of the enterprise in computing its taxable income. As such, the characterization of income in connection of property transfer is not important. There is no distinction between long-term and short-term gain.

The exchange of non-monetary assets by enterprises and the use of assets for donations, debt settlement, sponsorship, fund raising, advertisement, samples, staff welfare or profit distribution will be deemed as a transfer of assets.[25]

There is some unclarity on taxability on the disposal of listed shares of Chinese resident companies by non-resident enterprises. There are two types of shares that can be issued and traded on China stock exchanges. A-shares are issued by companies incorporated in mainland China and are traded in the mainland A-share markets. The prices of A-shares are quoted in Renminbi. Originally, only the PRC enterprises and individuals were allowed to trade A-shares. Since 2002, qualified foreign institutional investors (QFII) are allowed to trade A-shares. B-shares are issued by companies incorporated in mainland China and are traded in the mainland B-share markets. B-shares traded in Shanghai Stock Exchange are quoted in U.S. dollars and B-shares traded in Shenzhen Stock Exchange in Hong Kong dollars. Originally, only foreign enterprises and foreign individuals were allowed to trade B-shares. Starting from 2001, PRC individuals can trade B-shares with legal foreign currency accounts.

In 1993, the SAT issued a tax circular providing that foreign enterprises and foreign individuals are temporarily exempted from income tax on gain on transfer of B-shares.[26] The tax circular does not mention A-shares because then foreigners could not own A-shares. Chinese domestic enterprises have been subject to income tax on gain on the transfer of A-shares while Chinese individuals are temporarily exempted from income tax on A-shares trading since January 1, 1994.[27] When QFII started trading A-shares, it was not clear whether the tax treatment of gain derived by foreign enterprises on the transfer of B-shares should be applicable to A-shares. There were a lot of discussions about tax issues in relation to QFII. The rumor was that tax exemption was proposed. It appears that there were different opinions within the government authorities. In December 2005, the MOF and the SAT jointly issued a circular that only provided a

[25] Article 25 of the CIT Implementation Rules.

[26] Article 1(2) of Notice on the Issues Concerning Income Tax on Gain on Transfer of Stocks and Dividend Income of Foreign-invested Enterprises, Foreign Enterprises and Foreign Individuals, Guo Shui Fa [1993] No. 45, issued by the SAT on July 21, 1993.

[27] Notice on Temporary Exemption of Individual Income Tax on the Transfer of Shares, Cai Shui Zi [1994] No. 40, issued by the MOF and the SAT on June 20, 1994; Notice on Temporary Exemption of Individual Income Tax on the Transfer of Shares in 1996, Cai Shui Zi [1996] No. 12, issued by the MOF and the SAT on February 9, 1996; Notice on Continuing Temporarily Exemption of Individual Income Tax on the Transfer of Shares, Cai Shui Zi [1998] No. 61, issued by the MOF and the SAT on March 30, 1998 and effective on January 1, 1997.

Business Tax exemption on trading gain of QFIIs without mentioning income tax treatment.[28] In practice, QFIIs did not pay income tax on the trading gains and some of them may rely on tax treaty protection. In January 2009, the SAT issued a tax circular providing that QFII is subject to 10 percent withholding tax on dividends from resident enterprises.[29] Again, the tax circular is silent on the tax treatment of gains on the transfer of shares by QFII. In another tax circular concerning the administration of CIT on the transfer of resident enterprises by non-resident enterprises, the SAT states that that tax circular does not apply to the shares of Chinese resident enterprises bought and sold by non-residents that are publicly traded at stock exchanges.[30] The tax circular addresses the tax treatment of transfer of equity of resident enterprises by non-resident enterprises and the computation of gain or loss on the transfer. One view is that, as the circular excludes publicly traded shares bought and sold at exchanges, the transfer of those listed shares by non-residents should not be taxable. Another view is that such exclusion merely means that the circular does not apply to those transactions and does not mean the transactions are not taxable; the SAT may issue a separate circular to cover those transactions at a later date. The latter view sounds more appropriate.

It is clear that under the CIT Law and the CIT Implementation Rules the transfer of equity interest in a resident enterprise by a non-resident enterprise should be subject to a 10 percent CIT. Although there is unclarity in practice concerning listed shares because of the past exemption on gains on B-share trading and silence on QFII tax circulars, listed shares should not be different from other equity investment unless otherwise provided. Accordingly, under the CIT Law and the CIT Implementation Rules, non-resident enterprises should be subject to a 10 percent CIT on the gain on transfer of listed shares of resident enterprises. Various cases reported concerning the collection of CIT on the transfer of shares of listed resident enterprises by non-resident enterprises have confirmed the enforcement of this rule.[31]

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[28] Notice of the Ministry of Finance and the SAT on Business Tax Policy Concerning QFIIs, Cai Shui [2005] No. 155, issued on December 1, 2005.

[29] Notice of the SAT Concerning Corporate Income Tax Issues on Dividends Paid by Resident Enterprises to QFII, Guo Shui Han [2009] No. 47, issued on January 23, 2009.

[30] Article 1 of the Notice on Strengthening the Administration of Corporate Income Tax Concerning Equity Transfer for Non-resident Enterprises, Guo Shui Han [2009] No. 698, issued by the SAT on December 10, 2009 and effective on January 1, 2008.

[31] The non-resident corporate shareholders sold some of the listed shares through a Chinese securities brokerage firm. Huanshan State Tax Bureau in Anhui Province collected withholding tax of RMB 12.62 million or 10 percent of gain on the shares sold by non-resident enterprises on stock exchange. *Foreign Shareholders Paid Withholding Tax in Huanshan*, China Taxation News, November 3, 2008. Fuzhou State Tax Bureau in Fujian Province collected withholding tax of RMB 357 million on gain on A-shares sold by a Hong Kong company on stock exchange. *A Hong Kong Company Paid RMB 357 million Withholding Tax in Fujian on Reduction of A-share Holding*, China Taxation News, June 30, 2010.

4.4 Dividends

Dividends, profit distributions, and other returns on equity investments are income derived by an enterprise from investees on account of equity investments. Dividends, profit distributions, and other returns on equity investments shall be recognized on the date on which the investee resolves to make profit distribution.[32] This usually is the date when the shareholder meeting of a dividend-paying enterprise decides to make the dividend distribution regardless of whether the investing enterprise actually receives the distribution. If an enterprise has capital surplus as a result of issuing price in excess of par value and if the enterprise converts such capital surplus into stock, such stock is not traded as dividends to shareholders; the shareholders cannot increase their tax basis in equity investment in the enterprise.[33]

If a resident enterprise directly invests in another resident enterprise, the dividends received from the invested enterprise are exempted from CIT.[34] However, the tax-exempted dividend does not include income derived from investments in publicly issued and traded shares of a resident enterprise that are held for less than 12 consecutive months.[35] This exception creates some ambiguities. If a resident enterprise has an unlisted subsidiary, the resident parent enterprise is exempted from CIT on the dividends paid by the subsidiary. It is not clear whether the parent will be liable for CIT on the dividends if and when the subsidiary is subsequently listed because the parent has held the tradable shares for less than 12 months. Arguably, the parent company should continue to enjoy CIT exemption on the dividends as the shares held by the parent company are not those issued to the public, and the holding period prior to the IPO should be accounted for. This interpretation would be in line of the tax policy eliminating double taxation.

On and after January 1, 2008, non-resident enterprises are subject to a 10 percent withholding tax on the dividends received from Chinese resident enterprises that are not effectively connected with an establishment or a place of business in China. This withholding tax is also applicable to dividends paid by resident enterprises to QFIIs.[36] Such a tax rate may be reduced under tax treaties or arrangements. Under FEIT Law effective prior to 2008, foreign investors are exempted from income tax on dividends received from foreign invested enterprises.[37] On and after January 1, 2008, if a foreign invested enterprise pays dividends to a foreign investor out of the profits generated by the foreign invested enterprise prior to January 1, 2008, the foreign investor should not be

[32] Article 17 of the CIT Implementation Rules.

[33] Article 4 of the Notice on Certain Tax Policies on the Implementation of Corporate Income Tax Law, Guo Shui Han [2010] No. 79, issued by the SAT on February 22, 2010.

[34] Article 26 of the CIT Law.

[35] Article 83 of the CIT Implementation Rules.

[36] Guo Shui Han [2009] No. 47.

[37] Article 19 of the FEIT Law.

subject to withholding tax on the pre-2008 profits.[38] Where a wholly foreign owned enterprise or Chinese-foreign joint venture company has pre-2008 profits, it may identify the amount of pre-2008 profits in its board resolution, supported by an audited financial statement. For the resident enterprises listed on domestic stock exchanges (issuing A-shares and B-shares) or foreign stock exchanges (issuing overseas shares), they may regularly distribute dividends. However, those distributions may be made from an accumulated earning pool, without specifically identifying profit years. A SAT circular provides that when a listed resident enterprise distributes dividends for 2008 and after to non-resident enterprise shareholders of A-shares, B-shares, or overseas shares, the resident enterprise should withhold 10 percent withholding tax.[39] Non-resident shareholders may claim a tax refund if the withholding tax rate under applicable tax treaties is lower than 10 percent.[40]

4.5 Interest Income

Interest refers to revenue derived by an enterprise from the provision of funds for the use by others that does not constitute an equity investment, or from the use of its funds by others, including deposit interest, loan interest, bond interest, arrears interest, etc.[41] Interest received by a resident enterprise is includable in gross income of the enterprise. Where a finance enterprise makes a loan that is not overdue, it should recognize interest income on date that interest is due and payable in accordinace with the loan agreement. The principle of interest first and principal later should apply to the recognition of such interest. For an overdue loan, the finance enterprise should recognize interest income on the date that it actually receives the interest payment or, although it has not received the payment, the date that the enterprise recognizes interest income for accounting purposes.[42] If a finance enterprise has recognized interest income and the such interest have not been paid over ninety days after the due date, the enterprise can reduce income in the current period by such overdue amount.[43] After such write-off of interest income, if the enterprise recovers any amount in a subsequent period, it should recognize such

[38] Article 4 of the Notice of Certain Corporate Income Tax Incentive Issues, Cai Shui [2008] No. 1, issued by the MOF and the SAT on February 22, 2008.

[39] The Reply on the Corporate Income Tax Issue Concerning Dividends on B Shares and Other Shares Received by Nonresident Enterprises, Guo Shui Han [2009] No. 394, issued by the SAT on July 24, 2009.

[40] Notice on Withholding Tax Issues Concerning Dividends Paid by a Resident Enterprise to Nonresident Enterprise H Shareholders, Guo Shui Han [2008] No. 897, issued by the SAT on November 6, 2008; Guo Shui Han [2009] No. 394.

[41] Article 18 of the CIT Implementation Rules.

[42] Article 1 of Public Notice on the Issue of Recognition of Interest Income by Fiance Enterprises, SAT Gong Gao [2010] No. 23, issued by the SAT on November 5, 2010 and effective on December 4, 2010.

[43] Article 2 of SAT Gong Gao [2010] No. 23.

amount as income in the subsequent period.[44] There is no separate tax rate applicable to interest. Non-resident enterprises are subject to a 10 percent withholding tax on the interest received from China that is not effectively connected with an establishment or a place of business in China. This withholding tax is also applicable to interest paid by resident enterprises to QFIIs.[45] Such a tax rate may be reduced under tax treaties or tax arrangements.

Guarantee fees received by non-resident enterprises most likely will be treated as interest income. According to a tax circular issued under FEIT Law, a China-sourced guarantee fee received by a foreign enterprise that is not effectively connected with the establishment or place of business of the foreign enterprise in China is treated as interest income to the foreign enterprise. A China-sourced guarantee fee refers to the fee paid by enterprises, institutions, and individuals within China for the provision of guarantee by enterprises outside China for economic activities such as loans, buy and sale, cargo transportation, processing, leasing, and engineering projects.[46] Although FEIT Law has been replaced by the CIT Law, the treatment of guarantee fees most likely will be the same.

Interest from state treasury debts is exempt from CIT.[47] State treasury debts are those issued by the finance department of the State Council.[48] The Ministry of Finance can issue bonds on behalf of provincial and municipal governments. The interest on those bonds will be treated as that on state treasury debts and exempt from CIT.

4.6 Rental Income

"Rentals" refers to revenue derived by an enterprise from the provision of right to use fixed assets, packaging devices, or other tangible assets for a defined period of time. Rental income shall be recognized on the date on which the rent becomes payable under the contract.[49] If the leasing term provided in a contract is a period across two calendar years and the lessee pays the full amount of rent upfront, the lessor can allocate the rental income to the relevant tax year using a straight line in accordance with matching principle.[50] Non-resident enterprises are subject to a 10 percent withholding tax on rental income derived from China that is not effectively connected with an establishment or place of business in China. As discussed in Chapter 2.2.2, rental income is considered

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44 Articcle 3 of SAT Gong Gao [2010] No. 23.

45 Guo Shui Han [2009] No. 47.

46 Notice Concerning Income Tax Treatment of Guarantee Fee Derived by Foreign Enterprises from China, Cai Shui Zi [1998] No.1, issued by the MOF and the SAT on March 1, 1998.

47 Article 26(1) of the CIT Law.

48 Article 82 of the CIT Implementation Rules.

49 Article 19 of the CIT Implementation Rules.

50 Article 1 of Guo Shui Han [2010] No. 79.

derived from China if the enterprise, establishment, or place of business that bears or pays the income is located in China.[51] According to this sourcing rule, a non-resident enterprise may be subject to CIT on rental income for the use of assets by a Chinese entity where the assets are not necessarily located in China. In 1998, the SAT issued a circular under the FEIT Law, which provides that if foreign enterprises own telecommunication facilities such as satellites, cables, and fiber optic cables, and provide the right to use such facilities to the enterprises or individuals in China, the income derived from the activities is rental income subject to income tax in China.[52]

In 1999, the SAT reconfirmed this position in a letter reply to Beijing State Tax Bureau concerning the tax treatment of income of leasing transponder time on satellite received by Pan American Satellite.[53] In that case, China Central Television (CCTV) rented satellite transponder time from Pan American Satellite, a U.S. company, and Pan American Satellite transited data using satellites in outer space and ground facilities in the United States. The ground facilities in China were not owned and operated by Pan American Satellite. Beijing State Tax Bureau requested the satellite owner pay withholding tax on rentals paid by CCTV. Pan American Satellite brought an action against Beijing State Tax Bureau. Beijing First Intermediate People's Court held that as Pam American Satellite provided CCTV with certain bandwidth through its satellite, the fee for use of such facilities constituted royalties for use of or the right to use, industrial, commercial, or scientific equipment under the China-U.S. income tax treaty and subject to income tax in China. Beijing High People's Court confirmed the decision of Beijing Intermediate People's Court on appeal.[54] The two SAT circulars above were issued under Article 19 of FEIT Law and Article 6 of FEIT Regulations. The tax circulars technically become invalid because the FEIT Law and FEIT Regulations are no longer valid. However, the principle provided in Article 19 of FEIT Law and Article 6 of FEIT Regulations regarding rental income to non-resident enterprises has been incorporated in Article 3(3) of the CIT Law and Article 7(5) of the CIT Implementation Rules. The tax circulars and the Beijing court decision have shown the broad interpretation of China-sourced income by the Chinese tax authorities and Chinese court.

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[51] Article 7(5) of the CIT Implementation Rules.

[52] Notice on the Issue Concerning Tax on Income Derived from Renting Satellite Telecommunication Lines by Foreign Enterprises, Guo Shui Fa [1998] No. 201, issued by the SAT on November 12, 1998.

[53] Reply on Income Tax Issue Concerning the Income Received by Pan American Satellite on Leasing Satellite Transponder Time to CCTV, Guo Shui Han [1999] No. 566, issued by the SAT on August 19, 1999.

[54] Pan American Satellite vs. Beijing State Tax Bureau, Beijing High People's Court [2002] Gao Hang Zhong Zi No. 168, *available at* http://vip.chinalawinfo.com.

4.7 Royalties

"Royalties" refers to the revenue derived by an enterprise from the provision of the right to use patents, non-patented technologies, trademark, copyrights and other licensed rights. Royalties shall be recognized on the date on which the royalties become payable under the contract.[55] Royalties received by a resident enterprise are includable in gross income of the enterprise. Generally speaking, it is not important for a resident enterprise as to whether characterize income as royalties or other types of income, as in most cases the same tax rate should be applicable. Non-resident enterprises are subject to a 10 percent withholding tax on royalty income derived from China that is not effectively connected with an establishment or place of business of the enterprise in China. Whether revenue received by a non-resident enterprise is classified as "royalty" or service income sometimes is important because the non-resident enterprise may not be subject to CIT on the services if the activities of the non-resident enterprise do not constitute a permanent establishment under an applicable tax treaty.

In determining whether a fee is considered as a service fee or royalty for the purpose of application of the treaty royalty article, the SAT states that if the technology provider provides support or supervision through its personnel, and receives service fees therefore in connection with the transfer or licensing of the technology, such service fees will be treated as royalties regardless of whether the service fees are included in the total price of technology or separately charged. However, if the services performed by those personnel of the technology provider constitute a permanent establishment in China, the services will be treated as services rather than royalty.[56]

Computer software licensing fees derived by a foreign enterprise are generally treated as royalties. In a computer and computer software import contract, if software is transferred as patented right or copyright, or there is any restriction on the use of transferred software, the fees received by a foreign enterprise for such software transfer should be treated as royalties.[57] The SAT further clarified that as long as any restriction is imposed on the users within China with respect to the scope, method, and time period of using computer software, the user fees derived by the foreign enterprise should be treated as royalties subject to withholding tax.[58] The royalty treatment also applies to reimbursement of allocation of software cost sharing within a group company. In a case where a German

[55] Article 20 of the CIT Implementation Rules.

[56] Article 5 of the Notice on the Relevant Issues of the Application of Royalty Article of Double Taxation Agreements, Guo Shui Han [2009] No. 507, issued by the SAT on September 14, 2009 and effective on October 1, 2009.

[57] Reply on the Issue Concerning Tax on Software Fee Derived by Foreign Enterprises, Cai Shui Wai Zi [1986] No. 235, issued by the MOF and the SAT on August 29, 1986.

[58] Reply on Tax Issues Concerning Fees for the Right to Use Computer Software Derived by Foreign Enterprises, Guo Shui Han Fa [1994] No. 304, issued by the SAT on June 14, 1994.

company provides IT support to all of its subsidiaries in the world, including the provision of the information system, acquisition of software, and the provision of maintenance and technical supports, the SAT held that the fees paid by the Chinese subsidiary to its German parent company should be allocated to different items and treated separately. The reimbursement of the cost of software purchased by the German parent for the use of its Chinese subsidiary is treated as royalty income to the German parent subject to China withholding tax. The fees for IT maintenance services are not royalties because the services are not related to the transfer of proprietary technology. As such, the services performed outside China are not subject to China income tax.[59]

It should be noted that all the tax circulars discussed above were issued under the old tax law and regulations. The circulars themselves technically are not valid unless otherwise confirmed by the MOF and the SAT. However, the contents of the tax circulars do not seem contradict to any provisions of the CIT Law and the CIT Implementation Rules. Accordingly, unless otherwise interpreted by the MOF or the SAT, the circulars most likely can be used as reference in interpreting the new tax law and regulations.

4.8 Donation Income

Donation income is comprised of monetary and non-monetary assets received by an enterprise from other enterprises, organizations, or individuals without consideration. Donation income shall be recognized as revenue on the date on which the donation assets are actually received.[60] This time of income recognition is consistent with contract law. Under the contract law, a donor can revoke a donation contract any time before the transfer of property except for certain charitable donation contracts.[61] On and after November 26, 2010, an enterprise should recognize income on a donation in full amount without any exceptions.[62] If a donation is made in a non-monetary asset, the income recognized should be the fair market value of the asset. The SAT, in a tax circular issued under the FEIT Law, provides that if a foreign invested enterprise receives a donation of non-monetary assets including fixed assets, intangibles, and other goods, the enterprise shall recognize income based on the reasonable value of the assets. The enterprise may use its loss carryovers to offset such income; if the income after utilizing the loss carryovers is large and the enterprise has difficulties in paying the tax on donation income,

[59] Reply on Tax Issues Concerning the Provision of IT Maintenance Support and Consulting Services by Foreign Enterprises, Guo Shui Han [2005] No. 912, issued by the SAT on September 25, 2005.

[60] Article 21 of the CIT Implementation Rules.

[61] Article 186 of PRC Contract Law.

[62] Public Notice on the Issues of Corporate Income Tax Treatment of Income Derived by Enterprises on the Transfer of Property, SAT Gong Gao [2010] No. 19, issued by the SAT on October 27, 2010 and effective on November 26, 2010.

the enterprise may recognize income for five years using the straight-line method upon the approval of the tax authorities in charge.[63] The circular issued in October 2010 clarifies that this five-year income recognition rule is no longer available on and after November 26, 2010. Furthermore, if an enterprise adopted the five-year income recognition method for a donation received between January 1, 2008 and October 27, 2010, the enterprise should take the full unrecongized balance as income for the tax year of 2010.[64]

4.9 Income from Real Estate Development

It may take a few years to develop a real estate development project. The developer of a project may start selling units before completing the project. Due to the special nature of real estate development, the SAT issued a circular concerning CIT treatment of the business.[65] The tax circular is applicable to enterprises that are engaged in real estate development within the territory of China.[66] Real estate development business includes land development, construction, and the sale of residential or commercial buildings, attachments, and relevant facilities. Except for land development, the product developed is considered complete if (1) the documents evidencing the completion have been submitted to the competent government authority for registration, (2) the product developed has been placed in service, or (3) the initial property ownership certificate has been obtained.[67] For the real estate products developed by a real estate development enterprise, the real estate product development will be considered complete as long as the enterprise starts product handover formalities or the products are placed into service regardless of whether the products pass quality inspection or whether the enterprise files completion registration or completes final accounting.[68]

The sale revenue of real estate development is all the income received during the development process, including cash, cash equivalents, and other economic benefits. The funds, fees, and surcharges collected by an enterprise shall be treated as income if the items are included in the product price for which the enterprise issues invoice. If the items are not included in the product price and the invoices are issued by the collecting entities other than the real estate development enterprise, such items can be treated as

[63] Notice on the Issues Concerning the Donations Received by Foreign Invested Enterprises and Foreign Enterprises, Guo Shui Fa [1999] No. 195, issued by the SAT on October 18, 1999.

[64] SAT Gong Gao [2010] No. 19.

[65] The Measures on the Corporate Income Tax Treatment of Real Estate Development Business, Guo Shui Fa [2009] No. 31, issued by the SAT on March 6, 2009 and effective on January 1, 2008.

[66] Article 2 of Guo Shui Fa [2009] No. 31.

[67] Article 3 of Guo Shui Fa [2009] No. 31.

[68] Notice of the Conditions for Recognition of Completion of Product Development for Real Estate Development Enterprises, Guo Shui Han [2010] No. 201, issued by the SAT on May 12, 2010.

received on behalf of others (i.e., not treated as income of the enterprise).[69] The revenue received by an enterprise by entering into real estate sale contracts or real estate pre-sale contracts shall be recognized by the enterprise, specifically:

(1) If the contract price is paid in a lump sum, the income should be recognized on the date that the enterprise actually receives the payment or the evidence to claim the payment;[70]
(2) If the contract price is paid in installments, the income should be recognized on the date of payment provided the contract; if the actual payment is earlier than the contract payment date, the income should be recognized on the actual payment date;[71]
(3) If the property is financed by a bank mortgage, the down payment should be recognized as income on the date of actual payment; the balance of the bank loan should be recognized as income on the date of the bank fund transfer;[72]
(4) If a real estate developer sells real estate products through a sale agent, the income recognition depends on the types of arrangement with the agent:[73]
    (i) If the enterprise sells real estate products by paying a commission to the agent, it recognizes the revenue as provided in the sale contract when it receives a confirmation of sale from the agent;
    (ii) If the arrangement is a deemed buy/sell by an agent (i.e., the "sale price" to the agent is fixed between the enterprise and the agent) when the enterprise signs a sale contract with a buyer, or the enterprise, the agent, and a buyer sign a three-party contract, the income should be recognized by the enterprise in the amount of either the deemed sale price to the agent or the actual sale price in the buyer contract, whichever is higher. Such income should be recognized when the enterprise receives a confirmation of sale from the agent;
    (iii) If the agent guarantees a base price and the portion of the sale price exceeding the base price is shared between the enterprise and the agent, when the enterprise signs a sale contract with a buyer or the enterprise, the agent, and a buyer sign a three-party contract and the contract price is higher than the base price, the enterprise should recognize the full contract price as income upon the confirmation of sale of the agent. Where the contract price is lower than the base price, the enterprise should

[69] Article 5 of Guo Shui Fa [2009] No. 31.
[70] Article 6(1) of Guo Shui Fa [2009] No. 31.
[71] Article 6(2) of Guo Shui Fa [2009] No. 31.
[72] Article 6(3) of Guo Shui Fa [2009] No. 31.
[73] Article 6(4) of Guo Shui Fa [2009] No. 31.

recognize the base price as income upon the confirmation of sale of the agent; and

(iv) If the arrangement is that the agent guarantees to sell all of the property units within a certain period, the income recognition by the enterprise should be in reference to the methods described in (i)–(iii) based on the contract terms. At the end of the agreed sale period, if some inventories are not sold, the enterprise should recognize income in relation to the unsold inventories based on the price and payment terms as provided in the contract between the agent and the enterprise.

If an enterprise uses the property developed for donation, sponsorship, employee welfare, award, investment, distribution to shareholders or investors, repayment of debt, or exchange for non-monetary assets from other enterprises or individuals, the property should be deemed to be sold at the time that ownership of or the right to use the property is transferred or the time that the enterprise actually receives the beneficial interest. The income or profits as a result of the deemed sale should be determined based on the factors in the following order:[74]

(1) the sale price for the same type of products sold by the enterprise recently or the market price for the sale of the same type of products in the most recent month of current year;
(2) the assessment of the tax authority in charge in reference to fair market value of similar type of products;
(3) the development costs plus profit margin. Such profit margin should be determined by the tax authority but shall be no less than 15 percent.

The tax authorities of provinces, autonomous regions, and municipalities may determine the gross profit margin of sale of uncompleted products based on the following guidance:[75]

(1) If the development project is located in the urban districts or suburbs of the cities where the governments of provinces, autonomous regions, municipalities directly under the Central Government or the cities specifically designated in the state plan are located, the gross profit margin shall not be less than 15 percent;
(2) If the development project is located in prefecture-level cities or the suburbs of those cities, the gross profit margin shall not be lower than 10 percent;

[74] Article 7 of Guo Shui Fa [2009] No. 31.

[75] Article 8 of Guo Shui Fa [2009] No. 31.

(3) If the development project is located in other areas, the gross profit margin shall not be lower than 5 percent;
(4) If the project is an economical house, a price limited house or a rebuilt house, the gross profit margin shall not be lower than 3 percent.

When an enterprise sells developed products before full completion, the enterprise will not know its accurate tax basis in the products. In such a situation, the enterprise should calculate its taxable income for each quarter (or month) based on an estimate gross profit margin. When the project is completed, the enterprise should compute its tax basis in the project and actual gross profit margin and include the true-up of gross profit margin in the current year taxable income.[76] If a lease agreement is signed before the completion of a new development project or before the initial property registration is completed or before the ownership certificate is obtained, the lesser should recognize the lease payment as rental income at the time of delivery of property for the use of lessee.[77]

A cooperative housing development is a contractual arrangement to develop a real estate project. If a real estate development enterprise enters into a cooperation agreement with another enterprise, organization, or individual to develop real estate products where other parties invest in the housing project and the project itself is not a separate legal-person enterprise, the enterprise should account for income in the following manner based on the distribution arrangement. First, if the cooperation agreement provides that the other parties will receive distributions in the form of developed products, the enterprise should include the difference between the amount invested by the other parties and the tax basis of the products to be distributed in its taxable income at the time of initial distribution, if the tax basis of the project has been finalized at that time. On the other hand, if the final tax basis of the project has not been determined at the time of such distribution, the full amount of investment made by the other parties is deemed to be revenue of the enterprise. Secondly, if the cooperation agreement provides that other parties will receive profits from the sales of developed products, the profits distributed to the other parties are treated as dividend distributions. In such case, the enterprise should include the business profits from the project in its taxable income; the enterprise can neither deduct any profit distributions in computing its taxable income nor amortize interest, if any, charged by the other parties for the investment.[78]

If an enterprise contributes its land use right into a development project in exchange for developed products, the contributing enterprise is treated to sell the land use right first and then purchase the real estate products. At the time of receiving initial products

[76] Article 9 of Guo Shui Fa [2009] No. 31.
[77] Article 10 of Guo Shui Fa [2009] No. 31.
[78] Article 36 of Guo Shui Fa [2009] No. 31.

distribution, the contributing enterprise should recognize gain or loss on the deemed transfer of land use right based on the fair market value of the products received and/or to be received.[79]

4.10 Other Revenue

Other revenue is a catch-all provision to cover all income not separately listed in the tax law. Other revenue includes revenue from asset surpluses, deposits on packaging devices that are overdue for return, accounts payable that cannot be settled, recoveries on accounts receivable that have been written off as bad debts, revenue from debt restructuring, subsidies, compensations for the breach of contracts, exchange gains, etc.[80]

On April 30, 2009, the MOF and the SAT jointly issued the Notice on Certain Issues of Corporate Income Tax Treatment of Enterprise Reorganizations, Cai Shui [2009] No. 59. An enterprise debt restructuring is characterized as enterprise reorganization by the tax circular. According to the tax circular, a debt restructuring is a concession made by a creditor based on written agreement between the debtor and creditor or a court decision where the debtor enterprise is in financial difficulties. If an enterprise settles its debt with non-cash assets, the debtor enterprise is treated to sell the assets at fair market value and then pay the debt. The enterprise will recognize gain or loss on the deemed assets sale and then gain or loss on the debt settlement. If the creditor converts its debt into equity of the debtor, the conversion is treated as payment of debt by the debtor first and then as an investment by the creditor. In such deemed debt repayment, the debtor enterprise should recognize gain or loss on the settlement. The tax circular does not provide how the gain or loss should be computed. Presumably, the deemed cash repayment should be the fair market value of the equity issued to the creditor. As such, if an insolvent enterprise converts debt into equity, the enterprise may need to recognize gain on the debt settlement. The enterprise may have sufficient loss carryovers to shelter such gain. If the debtor pays less than full amount of debt in a debt restructuring, the debtor should recognize gains on the difference between its tax basis in the debt and the amount paid; the creditor should recognize losses on the difference between its tax basis in the debt and the amount received. The debt restructuring income should be recognized at the time where the restructuring agreement becomes effective.[81] Cai Shui [2009] No. 59 classifies enterprise reorganization into ordinary reorganization and special reorganization. If an enterprise debt restructuring satisfies the requirements for special reorganization and the taxable income realized as a result of the debt restructuring is more than 50 percent of current year taxable income, the debtor can elect to recognize the debt restructuring income in

[79] Article 37 of Guo Shui Fa [2009] No. 31.

[80] Article 22 of the CIT Implementation Rules.

[81] Article 2 of Guo Shui Han [2010] No. 79.

equal installments for five years. Furthermore, if an enterprise debt restructuring satisfies the special reorganization requirements, the debtor can elect not to recognize gain or loss on a conversion of debt into equity. For detailed requirements of special reorganization, please see Chapter 7.4.

Many State-controlled listed companies in China issued both tradable and non-tradable shares. Non-tradable shares include "state-owned share" and "legal-person shares." State-owned shares are owned by the State or state-owned organizations that hold investments on behalf of the Sate. State-owned shares were issued for new capital investment made by the State or the consideration of existing assets of a State-owned enterprise before restructuring. Legal-person shares were issued to corporations or other entities with legal-person status for investment made by those entities. The non-tradable shares were result of reform of State-owned enterprises. In 2005, the split-share structure reform was launched where listed companies form their own plans to convert non-tradable shares into tradable shares. Typically, non-tradable shareholders will pay considerations in cash or shares to tradable shareholders or issuing corporations in exchange for the trading rights for those shares. The tradable shareholders that receive shares or cash in such split-share structure reform are temporarily exempted from income tax.[82] Where a listed company (i.e., issuer of non-tradable shares) receives consideration in assets or debt forgiveness from non-tradable shareholders in such split-share structure reform, the listed company should increase its registered capital or capital surplus by the amount of consideration and should not be subject to CIT on the consideration.[83]

Government financial subsidies to enterprises may be subject to CIT. Funds allocated by the government at various levels for public institutions, social bodies, and other organizations that are under the budgetary administration of the government are generally non-taxable.[84] For business enterprises, however, the funds received from the government are not taxable only if the funds are used for specific purposes as designated by the department of the State Council in charge of finance and taxation and are approved by the State Council.[85] The MOF and the SAT, with the approval of the State Council, issued a notice that provide a favorable CIT treatment of government subsidies received by enterprises for the period from January 1, 2008 to December 31, 2010. During this period, if an enterprise receives financial subsidies to be used for a specific purpose from government at the county level or above, the enterprise may exclude the subsidies from its gross income if (1) the enterprise provides a funding document that stipulates specific use of

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[82] The Notice on Relevant Tax Policy Issues Concerning Split-Share Structure Reform, Cai Shui [2005] No. 103, issued by the MOF and the SAT on June 13, 2005, and validated by Cai Shui [2008] No. 1.

[83] Reply on the Issue Concerning Income Tax Exemption on Consideration in Assets or Debt Forgiveness Received by Listed Companies in Split-Share Structure Reform, Guo Shui Han [2009] No. 375, issued by the SAT on July 13, 2009.

[84] Article 7(1) of the CIT Law and Article 26 of the CIT Implementation Rules.

[85] Article 7(3) of the CIT Law and Article 26 of the CIT Implementation Rules.

the fund; (2) the funding government authorities have specific measures for administration of funds; and (3) the enterprise maintains separate accounting for the funds. To enjoy the CIT exclusion treatment, the enterprise should use the special purpose funds within sixty months; if any portion of the funds remains after sixty months of the tax exclusion year and is not returned to the government, the enterprise is required to include the remaining balance in the gross income of the enterprise for the sixth year.[86] The enterprise cannot deduct expenses or depreciate or amortize assets paid out of the non-taxable special purpose funds.[87]

[86] Notice on Corporate Income Tax Treatment of Financial Subsidies to Be Used for Specific Purpose, Cai Shui [2009] No. 87, issued by the MOF and the SAT on June 16, 2009 and effective from January 1, 2008 to December 31, 2010.

[87] Article 28 of the CIT Implementation Rules;. Cai Shui [2009] No. 87.

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DEDUCTIONS

Reasonable expenses actually incurred by an enterprise in connection with the earning of revenue, including costs, expenses, taxes, losses, and other expenses, are deductible in arriving at taxable income for CIT purposes.[1] "Related expenses" refer to expenses that are directly related to the generation of revenue; "reasonable expenses" refer to necessary and normal expenses that are incurred in the ordinary course of production and business operations, and that should be taken into account in earning the profits or losses, or the costs of the related assets during the current period.[2] Expenditures incurred by an enterprise shall be classified into revenue expenditures and capital expenditures. Revenue expenditures shall be directly deducted in the period in which they are incurred; capital expenditures shall be deducted on a periodic basis or included in the cost of the related assets.[3] Expenses or assets that arise out of the disbursement of non-taxable revenue of an enterprise shall not be deducted, depreciated, or amortized.[4] "Costs" includes the cost of sales, cost of goods sold, business expenditures and other outlays incurred by an enterprise in the course of production and business operations.[5] "Expenses" includes selling

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[1] Article 8 of the CIT Law.

[2] Article 27 of the CIT Implementation Rules.

[3] Article 28 of the CIT Implementation Rules.

[4] Article 28 of the CIT Implementation Rules.

[5] Article 29 of the CIT Implementation Rules.

expenses, administrative expenses, and financial expenses incurred by an enterprise in the course of production and business operations, except for those that have been recorded as costs.[6]

An enterprise may deduct expenses corresponding to tax-exempted income in computing its taxable income unless otherwise specifically provided.[7]

5.1 Inventories

An enterprise can deduct the cost of inventories used or sold in computing its taxable income.[8] The inventories refer to products or merchandise that are held by an enterprise for sale, work in progress, or materials that are consumed in the process of production or provision of services. The costs of inventories should be determined using the following methods:[9]

(1) Where the inventories are acquired with cash, the costs shall be the purchase price and the related taxes and charges paid;
(2) Where the inventories are acquired with consideration other than cash, the costs shall be the fair value of the assets, related taxes, and charges paid; and
(3) For agricultural products that are derived from biological assets used for production, the costs shall be the materials costs, the labor costs, the shared indirect costs, and similar necessary expenditures that are incurred in the course of production or harvesting.

Enterprises may select the first-in-first-out method, the weighted average method or the specific identification method as their costing method for inventories that are used or sold by the enterprises. Once selected, the inventory costing method shall not be arbitrarily changed.[10]

5.2 Staff Expenses

5.2.1 SALARY AND WAGES

Reasonable salary and wage expenses incurred by an enterprise are deductible. Such expenses include all cash and non-cash remunerations that are paid by an enterprise to

[6] Article 30 of the CIT Implementation Rules.
[7] Article 6 of Guo Shui Han [2010] No. 79.
[8] Article 15 of the CIT Law.
[9] Article 72 of the CIT Implementation Rules.
[10] Article 73 of the CIT Implementation Rules.

its employees during each tax year, including basic wages, bonuses, allowances, subsidies, year-end extra salaries, overtime wages, and other expenditures.[11] The "reasonable salary and wage" refers to the salaries and wages actually paid to employees by an enterprise in accordance with the compensation rules that have been adopted by general shareholders' meeting, the board of directors, compensation committee, or other relevant management body of the enterprise. The tax authorities may confirm the reasonableness of salaries and wages based on the following principles:[12]

(1) The enterprise has formulated comparatively standardized employee wage and salary system;
(2) The wage and salary system formulated by the enterprise is in line with the industrial and regional level;
(3) The wage and salary paid by the enterprise in certain period are relatively stable, and the adjustment of wage and salary is undertaken with order;
(4) The enterprise has performed its obligation of withholding Individual Income Tax from wage and salary payments in accordance with law; and
(5) Arrangement relevant to wage and salary is not aimed to reduce or avoid tax payment.

For State-owned enterprises, salaries and wages shall not exceed the limited amount prescribed by relevant governmental department; the exceeded amount cannot be deducted for CIT purposes.[13]

The CIT Implementation Rules use the term "paid" regarding the deductibility of salary expenses. Tax authorities interpret that the salaries and bonus must be actually paid in order for an enterprise to claim a deduction. Accordingly, an enterprise will not be allowed to deduct accrued expenses for salaries and bonus on December 31 of a year if such salaries and bonus are actually paid in early January following the year. This interpretation is different from the common practice prior to the implementation of the CIT Law. Prior to the effectiveness of the CIT Law on January 1, 2008, accrued salaries and bonus were deductible if the accrued amount was actually paid on or before April 30 of the following year.

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[11] Article 34 of the CIT Implementation Rules.

[12] Article 1 of the Notice on Issues concerning Deduction of Salaries and Wages and Employee Benefits of Enterprises, Guo Shui Han [2009] No. 3, issued by the SAT on January 4, 2009 and effective on January 1, 2008.

[13] Article 2 of Guo Shui Han [2009] No. 3.

5.2.2 PENSION AND INSURANCE PREMIUMS

The deductibility of pension and insurance premiums paid for employees by an enterprise depends on the types of pension and insurance. Employers are required to make contributions to government-run social securities funds for their employees. Those mandatory contributions include basic pension premiums, basic medical insurance premiums, unemployment insurance premiums, work injury insurance premiums, maternity insurance premiums, and housing funds. These pension and insurance premiums and other similar basic social insurance premiums, as well as housing fund contributions that are paid by an enterprise for its employees in accordance with the scope and standards prescribed by the MOF and the SAT or the provincial People's Governments are deductible.[14] Supplemental pension premiums and supplemental medical insurance premiums paid by an enterprise for its investors and employees in accordance with the scope and standards prescribed by the MOF and the SAT are also deductible.[15] On and after January 1, 2008, the supplemental pension premiums and supplemental medical insurance premiums paid by an enterprise for all of its employees are each deductible up to 5 percent of total salaries and wages; the excess amount is not deductible.[16] Commercial insurance premiums paid by an enterprise for its investors or employees are not deductible except for personal safety insurance premiums paid for employees of special job categories in accordance with relevant government regulations and other commercial insurance premiums that are allowed as deductions by the MOF and the SAT.[17]

5.2.3 STAFF WELFARE EXPENSES

Staff welfare expenses incurred by enterprises are deductible up to 14 percent of the total salaries and wages.[18] The staff welfare expenses include:[19]

(1) The expenses incurred by an enterprise in running employee benefit facilities if those facilities are not operated in a separate entity or entities. Those facilities include dining rooms, bathhouses, barbershops, medical clinics, day care centers, sanatoriums and other similar internal benefit facilities. The expenses include the costs of equipment, facilities, and their repair and maintenance,

[14] Article 35 of the CIT Implementation Rules.

[15] Article 35 of the CIT Implementation Rules.

[16] Notice on Corporate Income Tax Policies Concerning Supplemental Pension and Supplemental Medical Insurance Expenses, Cai Shui [2009] No. 27, issued by the MOF and the SAT on June 2, 2009 and effective on January 1, 2008.

[17] Article 36 of the CIT Implementation Rules.

[18] Article 40 of the CIT Implementation Rules.

[19] Article 3 of Guo Shui Han [2009] No. 3.

as well as the salaries, wages, and social securities contributions for the staff working at those facilities;

(2) The subsidies and non-monetary benefits provided by an enterprise to its employees for health care, the cost of living, housing, transportation, etc., which include the expenses of work-related medical treatments to employees incurred in a business trip; the employee medical expenses where an enterprise has not participated in cooperative medical program; the subsidies for health care expenses incurred by employees for their family members and other dependents; the subsidies to employees for house heating, heatstroke prevention, hardship and other kinds of relief; transportation; the subsidies for the staff cafeteria; and

(3) Expenses for other employee benefits incurred by an enterprise according to other regulations, which include funeral expenses subsidies, payments for injury or death benefits, relocation allowance, and home leave transportation allowance.

The "total salaries and wages" refers to the total deductible salary and wage expenses in computing taxable income for CIT purpose (see details in Chapter 5.2.1). The total salaries and wages do not include staff welfare expenses, staff education expenses, labor union funds, and the contributions to pension and insurance premiums and housing funds (see details in Chapter 5.2.2). The salaries and wages for State-owned enterprises are subject to limitations prescribed by relevant governmental departments; the exceeded portion cannot be included in the total salaries and wages as the base for computing staff welfare expense limitation.[20] The expenses in excess of the limitation cannot be carried forward. If the current year expenses are less than 14 percent of the total salaries and wages, the unused amount of limitation cannot be carried forward.

An enterprise shall set separate accounting books for its staff welfare expenses, and shall keep accounts accurately. If the enterprise does not set separate accounting books for accurate accounts, the tax authorities shall require the enterprise to correct within a specified time period. If the enterprise fails to correct within the period, the tax authorities may deem staff welfare expenses based on reasonable methods.[21]

5.2.4 LABOR UNION FUND CONTRIBUTIONS

The staff and workers of an enterprise have the right to establish a trade union and carry out activities in accordance with the stipulations of the Trade Union Law of the PRC. An enterprise should contribute to its labor union an amount equal to 2 percent of total

[20] Article 2 of Guo Shui Han [2009] No. 3.

[21] Article 4 of Guo Shui Han [2009] No. 3.

salaries and wages, as part of the fund for the operations of the labor union.[22] Labor union funds contributed by an enterprise, to the extent that they are not exceeding 2 percent of the total salaries and wages, are deductible.[23] The deduction of union fund expenses should be supported by a special union fee receipt issued by a labor union.[24] The total salaries and wages do not include staff welfare expenses, staff education expenses, labor union funds, and the contributions to pension and insurance premiums and housing funds. The salaries and wages for State-owned enterprises are subject to limitations prescribed by relevant governmental departments; the exceeded portion cannot be included in the total salaries and wages as the base for computing labor union fund expense limitations.[25] The expenses in excess of the limitations cannot be carried forward.

5.2.5 STAFF EDUCATION EXPENSES

The government regulations require that an enterprise accrue staff education expense equal to 1.5 percent to 2.5 percent of total salaries and wages. The funds should be used by the enterprise for specific staff training and education, which may include various job training and skill training, continuing education of technical staff, expenditures for sending staff to outside training programs, expenditures for vocational qualification and certification, the acquisition of teaching equipment and facilities, the rewards for staff self study, the management expenses for staff education and training, and other expenses related to staff education.[26] Unless the departments of the State Council in charge of finance and taxation prescribe otherwise, staff education expenses that are incurred by an enterprise, to the extent not exceeding 2.5 percent of the total salaries and wages, shall be deductible; any excess amount may be carried forward and deducted in succeeding tax years.[27] The total salaries and wages do not include staff welfare expenses, staff education expenses, labor union funds, and the contributions to pension and insurance premiums

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[22] Article 42 of Labor Union Law of the PRC, adopted at the NPC on April 3, 1992 and amended by the Standing Committee of the NPC on October 27, 2001.

[23] Article 41 of the CIT Implementation Rules.

[24] Public Notice on the Issue Concerning the Evidence for Deduction of Union Fees for Corporate Income Tax Purposes, SAT Gong Gao [2010] No. 24. issued by the SAT on November 9, 2010 and effective from July 1, 2010.

[25] Article 2 of Guo Shui Han [2009] No. 3.

[26] Opinions on Administration of Provision and Use of Staff Education Expenses, Cai Jian [2006] No. 317, jointly issued by the MOF, the Federation of Trade Unions, the National Development and Reform Commission, the Ministry of Education, the Ministry of Science and Technology, the Commission of Science, Technology and Industry for National Defense, the Ministry of Personnel, the Ministry of Labor and Social Security, the State-Owned Assets Supervision and Administration Commission of the State Council, the SAT and the All-China Federation of Industry and Commerce on June 19, 2006.

[27] Article 42 of the CIT Implementation Rules.

and housing funds. The salaries and wages for State-owned enterprises are subject to limitations prescribed by relevant governmental departments; the exceeded portion cannot be included in the total salaries and wages as the base for computing staff education expense limitations.[28]

5.3 Entertainment Expenses

Entertainment expenses incurred by an enterprise in connection with production and business operations are deductible at 60 percent of the actual amount, but such deduction cannot exceed 0.5 percent of the sales (business) revenue of the year.[29] The current year disallowed amount of entertainment expenses cannot be carried forward. Except otherwise provided, a deemed revenue should be recognized by an enterprise where it exchanges non-monetary assets or use of goods, assets or services for donations, debt settlement, sponsorship, fundraising, advertisement, samples, staff welfare or profit distributions.[30] Such deemed revenue should be included in the revenue base in computing entertainment expense limitation.[31] For enterprises engaging in equity investments such as investment holding companies and venture capital investment enterprises, the dividends received from investees and the gains on transfer of equity should be considered as business revenue in computing entertainment expense limitation.[32]

5.4 Interest Expenses

Reasonable borrowing expenses that are incurred by an enterprise in the course of production and business operations are generally deductible. When an enterprise borrows funds in the course of the acquiring and construction of fixed assets, intangible assets, and inventories whose construction takes longer than 12 months to reach the expected saleable condition, reasonable borrowing expenses that are incurred during the period of relevant acquisition and construction shall be capitalized as costs of the relevant assets, and depreciated or amortized as part of the tax basis in the assets in accordance with the

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[28] Article 2 of Guo Shui Han [2009] No. 3.

[29] Article 43 of the CIT Implementation Rules.

[30] Article 25 of the CIT Implementation Rules.

[31] Notice on Tax Treatments of Certain Items in Implementation of Corporate Income Tax, Guo Shui Han [2009] No. 202, issued by the SAT on April 21, 2009.

[32] Article 8 of Guo Shui Han [2010] No. 79.

CIT Implementation Rules.[33] The following interest expenses incurred by an enterprise in the course of production and business operations are deductible:[34]

(1) Interest expenses incurred by non-financial institutions on loans from financial institutions;
(2) Interest expenses incurred by financial institutions on deposits and inter-bank borrowings;
(3) Interest expenses incurred by enterprises on bonds approved for issuance; and
(4) Interest expenses incurred by non-financial institutions on loans from non-financial institutions to the extent that they do not exceed the amounts calculated by reference to the interest rates applicable to loans of the same period and category made by financial institutions.

Deductions for interest expenses are subject to limitation under the thin capitalization rule. The thin capitalization rule sets forth a maximum related party debt to equity ratio of 5:1 for financial enterprises and 2:1 for other enterprises.[35] An enterprise may deduct interest actually paid to related parties within the permitted debt to equity ratio.[36] The interest on related party debt exceeding the permitted amount will not be deductible when computing taxable income for CIT purposes in the current year or future periods.[37] The related party debt includes not only direct loans from a related party but also a back-to-back loan where a related party provides through an unrelated party, an unrelated party loan guaranteed by a related party or secured by the assets of a related party, and other investment in the nature of a debt indirectly obtained from a related party.[38]

In computing the debt to equity ratio, only the debt and equity from a related party are considered, and unrelated party debt is excluded. For example, if a company with RMB100,000 equity borrows RMB100,000 from an unrelated bank and then takes a parent loan of RMB200,000, the related party debt to equity ratio is 2:1, whereas the enterprise's debt to equity ratio would be 3:1. In such a situation, the thin capitalization rules do not disallow an interest deduction on the parent loan.

33 Article 37 of the CIT Implementation Rules.

34 Article 38 of the CIT Implementation Rules.

35 Article 1 of the Notice on the Issues Concerning Taxation Policies for the Standards for Pre-Tax Deduction of Interest Payments Made to Related Parties, Cai Shui [2008] No.121, issued by the MOF and the SAT on September 19, 2008.

36 Article 1 of Cai Shui [2008] No.121.

37 Article 46 of the CIT law; Cai Shui [2008] No.121.

38 Article 119 of the CIT Implementation Rules.

The SAT provides a formula to compute the non-deductible interest expense:

$$\begin{aligned}&\text{Non-deductible interest expense}\\&\quad= \text{Annual interest actually paid to related parties}\\&\qquad\times \left(1 - \text{Standard ratio} \div \text{Related party debt to equity ratio of the enterprise}\right)\end{aligned}$$ [39]

"Interest actually paid" refers to interest recorded by the enterprise to relevant costs or expenses on an accrual basis.[40] Such interest expense includes not only interest on a loan but also the guarantee fee, mortgage fee, and other expenses of nature of interest.[41] The related party debt to equity ratio is the sum of average related party debt for each month in a year divided by the sum of average equity investment for each month in a year. In this formula:

$$\begin{aligned}&\text{Average related party debt for a month}\\&\quad= \left(\text{Opening balance of related party debt for the month}\right.\\&\qquad\quad\left.+ \text{Closing balance of related party debt for the month}\right) \div 2\end{aligned}$$

$$\begin{aligned}&\text{Average equity investment for a month}\\&\quad= \left(\text{Opening balance of equity investment for the month}\right.\\&\qquad\quad\left.+ \text{Closing balance of equity investment for the month}\right) \div 2\end{aligned}$$

Equity investment is the amount of shareholders' equity recorded on the balance sheet. If the amount of shareholders' equity is less than the sum of paid-in capital and capital reserve, equity investment is equal to the sum of paid-in capital and capital reserve. If the sum of paid-in capital and capital reserve is less than the amount of paid-in capital, equity investment is equal to the amount of paid-in capital.[42] Accordingly, the "equity investment" for the purpose of calculation of debt to equity ratio is (1) book net equity, (2) paid-in capital, or (3) the sum of paid-in capital and capital reserve, whichever is greater.

There are two exceptions to the permitted debt to equity ratio. The first exception is a proof of arm's-length transaction. If an enterprise can prove the related party loan complies with the arm's-length principle in the amount of lending, interest rate, term, financing requirements, and debt to equity ratio, the enterprise can deduct interest expenses on the related party loan in spite of the related party debt to equity ratio exceeding the

[39] Article 85 of the Implementation Rules for Special Tax Adjustments (Trial), Guo Shui Fa [2009] No. 2, issued by the SAT on January 8, 2009 and effective on January 1, 2008.

[40] Article 91 of Guo Shui Fa [2009] No. 2.

[41] Article 87 of Guo Shui Fa [2009] No. 2.

[42] Article 86 of Guo Shui Fa [2009] No. 2.

standard ratio. To qualify for this exception, an enterprise must prepare, maintain the following contemporaneous documents and, upon the request, submit them to the tax authorities:[43]

(1) Analysis of borrower's repaying ability and crediting ability;
(2) Analysis of repaying ability of the group and its financing structure;
(3) Explanation of changes in equity investment such as the registered capital;
(4) Explanation of the nature, purposes of related party debt and the market condition when receiving such financing;
(5) Currency denomination of related party debt, amount, interest rate, term and financing conditions;
(6) Condition of collaterals provided by the enterprise;
(7) Guarantor and the condition of guarantee;
(8) Interest rate of loans with same type and maturity, and financing conditions;
(9) Requirements for conversion of convertible debts; and
(10) Other documents that can prove compliance with the arm's-length principle.

The second exception is no tax rate disparity. If the actual tax burden of the borrowing enterprise is not higher than that of a related party lender within China, the borrowing enterprise can deduct the actual expense of interest payments to the related party. The second exception is not applicable to cross border transactions.[44]

Once an enterprise derives the non-deductible amount based on the above formula, it should allocate the amount among the related parties proportionately according to the interest actually paid to each related party. Such interests allocated to the related parties within China that have an actual CIT burden no less than that of the borrowing enterprise will be allowed to be deductible. Interest actually paid to overseas related parties directly or indirectly will be regarded as dividend distribution. If the CIT rate on the dividend is higher than the tax on the interest, additional tax based on the rate difference should be paid; if the withholding tax already paid on interest payment is more than that computed based on the deemed dividend, such excess amount is not refundable. Furthermore, the current year non-deductible interest expenses cannot be carried forward for future years.[45]

China foreign investment regulations provide for total investment to registered capital ratios. Registered capital is actual paid-in capital and total investment is registered capital plus debts. Theoretically, the debts may include all debts of an enterprise. In practice, only foreign debt is considered in computing the total investment to registered capital ratio

[43] Article 2 of Cai Shui [2008] No.121; Article 89 of Guo Shui Fa [2009] No. 2.
[44] Cai Shui [2008] No.121.
[45] Article 88 of Guo Shui Fa [2009] No. 2.

and enforced through the foreign debt registration process. An enterprise must register its foreign debt under China foreign exchange regulations. A foreign invested enterprise cannot register its foreign debt if the accumulated amount of the mid-to-long-term (more than one year) foreign loans and the balance of short-term loans (one year or less) exceed the difference between the total investment and the registered capital of the enterprise. Without proper registration, a foreign invested enterprise will not be able to convert the loan proceeds into RMB and remit the funds for payment of interest and principal.

The total investment to registered capital ratio is tested on an enterprise basis. For foreign debt registration purposes, all foreign debt of the foreign invested enterprise, including both related and unrelated debt, will be considered. Under the thin capitalization rule, only related party debt, including both foreign and domestic debt, will be considered. As a result, if all the debt financing of a wholly foreign owned enterprise is from its foreign parent company, the foreign invested enterprise can only take the loan amount which is the smaller under either the total investment to registered capital ratio under the foreign investment regulations, or the debt to equity ratio under the thin capitalization rule, as the basis for calculation. The following table compares the ratios under both foreign investment regulations and the thin capitalization rule that are applicable to non-financial foreign invested enterprises.

	Foreign investment regulations		Thin cap rule
Registered capital (USD in millions)	Total investment to registered capital	Approx equivalent of debt to equity	Debt to equity
Less than 2.1	1.43:1	0.43:1	2:1
2.1 to less than 5	2:1	1:1	2.1
5 to less than 12	2.5:1	1.5:1	2:1
12 and more	3:1	2:1	2:1
30 to less than 100 (Investment holding co. only)		4:1	2:1 (?)
100 or more (Investment holding co. only)		6:1	2:1(?)

A foreign investment holding company is a special vehicle that can be used by a foreign company to hold its China investments. Foreign investment regulations allow higher leverage for foreign investment holding companies than that for other non-financial enterprises. The thin capitalization rule does not provide any special debt to equity ratio for foreign investment holding companies. Presumably, the 2:1 ratio is also applicable to foreign investment holding companies. Given the higher leverage permitted

under foreign investment regulations, it may be easy for foreign investment holding companies to avail themselves of the arm's-length principle exception to the debt to equity ratio.

Interest paid between branches or establishments within non-bank enterprises is not deductible.[46]

When an enterprise is established, the investor or investors should contribute registered capital to the enterprise no later than the contribution schedules prescribed by the Article of Association of the enterprise in accordance with law and regulations. If an investor fails to contribute the required amount of registered capital according to the contribution schedule, the interest expense in relation to the unpaid registered capital is not deductible in computing taxable income for CIT purpose. Such interest expense is considered the expenses of investor and not related to the production or business operations of the enterprise. For the purpose of computing the non-deductible interest expense, it may be necessary to divide a tax year into several periods. One period is the time period for which both the amount of actual paid-in capital and the balance of the loan remain constant. The disallowed interest expense is computed based on the following formula:

$$\begin{aligned}&\text{Non-deductible interest for one period}\\&\quad = \text{Interest expense for the period} \times \text{Unpaid registered capital for the period}\\&\qquad \div \text{Loan for the period}\end{aligned}$$

The total non-deductible interest expense in relation to unpaid registered capital is the sum of non-deductible interest for all periods within a tax year.[47]

If an enterprise borrows from related individuals, the interest deduction limitation under the thin capitalization rule discussed above also applies. Additionally, an enterprise can only deduct interest expense on a loan from an individual if (1) there is a loan agreement between the enterprise and the individual; (2) the loan is true, legally valid and effective, and is not for illegal fundraising purposes or other acts in violation of laws and regulations; and (3) the deductible portion of interest paid cannot exceed the amount of interest computed using the interest rate on a loan in the same term and same category from a financial enterprise.[48]

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[46] Article 49 of the CIT Implementation Rules.

[47] Reply on Issues Concerning the Tax Deduction of Interest Expenses Due to Failure of Corporate Investors to Contribute Capital, Guo Shui Han [2009] No. 312, issued by the SAT on June 4, 2009.

[48] The Notice on the Issue of Deduction of Interest Expenses on Loans from Individuals for Corporate Income Tax Purpose, Guo Shui Han [2009] No. 777, issued by the SAT on December 31, 2009.

5.5 Research and Development Expenses

Enterprises generally can deduct research and development expenses actually incurred. Enterprises are also eligible for an additional deduction equal to 50 percent of qualified research and development expenditures.[49] For detailed discussions of additional deduction for research and development expenses, see Chapter 8.4 Super Deduction for Research and Development Expenditures.

R&D expenditures can be either currently deducted when incurred or capitalized as intangible assets and then amortized. The CIT Law and the CIT Implementation Rules do not provide guidance on the classification of R&D expenditures as current expenses or intangible assets. Normally, it is necessary for enterprises to follow PRC accounting standards. According to the Accounting Standard for Business Enterprises, an enterprise should classify its expenditures for R&D project into research expenditures and development expenditures. The term "research" refers to the creative and planned investigation to acquire and understand new scientific or technological knowledge. The term "development" refers to the application of research achievements and other knowledge to a certain plan or design, prior to the commercial production or use, so as to produce any new material, device or product, or substantially improved material, device, or product.[50] The research expenditures shall be expensed in the current period.[51] The development expenditures may be recorded as intangible assets if all the following conditions are met:[52]

(1) It is feasible technically to finish intangible assets for use or sale;
(2) It is intended to finish and use or sell the intangible assets;
(3) The usefulness of methods for intangible assets to generate economic benefits shall be proved, including being able to prove that there is a potential market for the products manufactured by applying the intangible assets or there is a potential market for the intangible assets itself or the intangible assets will be used internally;
(4) It is able to finish the development of the intangible assets, and able to use or sell the intangible assets, with the support of sufficient technologies, financial resources and other resources; and
(5) The development expenditures of the intangible assets can be reliably measured.

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[49] Article 30 of the CIT Law; Article 95 of the CIT Implementation Rules.

[50] Article 7 of Accounting Standard for Business Enterprises No. 6–Intangible Assets, Cai Kuai [2006] No. 18, issued by the MOF on October 30, 2006.

[51] Article 8 of Accounting Standard for Business Enterprises No. 6–Intangible Assets.

[52] Article 9 of Accounting Standard for Business Enterprises No. 6–Intangible Assets.

5.6 Leasing Expenses

Leasing expenses that are incurred by an enterprise on the lease of fixed assets are deductible provided such assets are required for production and business operations. The permissible methods of deduction depend on the classification of lease, i.e., operating lease or finance lease. If a lease is an operating lease, leasing expenses should be deducted evenly over the term of the lease. If a lease is a finance lease, the part of such expenses that constitutes the value of the fixed assets should be depreciated and deducted periodically.[53]

5.7 Management Fees

The CIT Implementation Rules provide that management fees paid between enterprises are not deductible.[54] Prior to January 1, 2008, the management fees paid by a foreign invested enterprise to affiliates were not deductible according to the FEIT Law; the management fees paid by domestic entities were not deductible unless specifically approved by the MOF or the SAT. The new CIT law and regulations most likely have adopted the same concept and disallow a deduction for related party management fees. It would be unreasonable to disallow a deduction of management fees paid for unrelated party management services. Management fees are not defined in the tax law and regulations. In practice, management fees typically include the overhead charges or stewardship charges from a parent company to a subsidiary. The provision does not prevent an enterprise from deducting related party service fees. As such, an enterprise may still claim a deduction for reasonable fees paid to related parties for specific services. The difficulty is to prove to the satisfaction of the tax authorities that the charges are for services, and that such charges are on an arm's-length basis.

Where a non-resident enterprise has set up an establishment or a place of business in the PRC, the expenses that are incurred by the head offices of the non-resident enterprise outside the PRC in connection with the production and business operations of such establishment and place of business shall be deductible.[55] Because of the practical restriction on registration of branches of foreign enterprises, such allowed deduction for overhead charges typically applies to branches of foreign banks and insurance companies. For example, if a foreign bank sets up a banking branch in China, the branch can deduct reasonable overhead charges from the head offices of the foreign bank. In order to claim a deduction for overhead charges, such expenses must be substantiated by documentation from the head offices certifying the scope of the expenses to be allocated, the amount

[53] Article 47 of the CIT Implementation Rules.

[54] Article 49 of the CIT Implementation Rules.

[55] Article 50 the CIT Implementation Rules.

involved, the basis and methodologies of allocation, etc. and that such allocation is reasonable.[56]

5.8 Donations

Donations made by an enterprise for public welfare are deductible in calculating taxable income subject to the limitation of no more than 12 percent of total profit in the current year.[57] The "total profit" is the accounting profit before income tax of the enterprise for the year calculated based on accounting standards of the PRC.[58] The CIT Law and the CIT Implementation Rules do not provide a carryover of donation expenses. As such, any charitable donations in excess of the current year limitation should become a permanent non-deductible expense.

To be deductible expenses, donations must be made through social organizations serving public welfare or People's Governments, at or above the county level (including the departments of those governments), that are used for public welfare undertakings prescribed by the Welfare Donations Law of the PRC.[59] Those undertakings include those for: (1) disaster relief, poverty relief, and supporting disabled people or other unprivileged social groups or individuals; (2) educational, scientific, cultural, public health, and sports; (3) environmental protection and public facility construction; and (4) other public and welfare services to promote social development and progress.[60]

The social organizations serving the public welfare are foundations, charitable organizations, and similar social organizations that meet the following criteria:[61]

(1) They are registered according to the law and have a legal person status;
(2) Their mission is to pursue public welfare undertakings, and their objective is not to make profits;
(3) All assets and their appreciation are owned by the legal persons;
(4) Earnings and operating surplus are used primarily in undertakings that are consistent with the goals of the legal persons;
(5) Upon termination, the remaining assets do not belong to any individuals or for-profit organizations;

56 Article 50 of the CIT Implementation Rules.

57 Article 9 of the CIT Law.

58 Article 53 of the CIT Implementation Rules.

59 Article 51 of the CIT Implementation Rules.

60 Article 3 of the Notice on Relevant Issues of Pre-tax Deduction of Charitable Contribution, Cai Shui [2008] No. 160, issued by the MOF, the SAT, and the Ministry of Civil Affairs on December 31, 2008 and effective on January 1, 2008.

61 Article 52 of the CIT Implementation Rules.

(6) They do not engage in any business that is not relevant to their established goals;
(7) Their donors do not participate in the distribution of the assets of the social organizations in any way or form; and
(8) They meet other criteria that the departments of the State Council in charge of finance and taxation may prescribe in conjunction with the civil affairs departments of the State Council and similar registration and administrative departments.

The foundations, charitable organizations, and similar social organizations that meet the above criteria may apply for the certification of organizations qualifying for receiving tax-deductible donations. If the organization is established with an approval of the Ministry of Civil Affairs, the organization must apply to the Ministry of Civil Affairs, the MOF, and the SAT, separately. If the organization is a foundation approved by a provincial bureau of civil affairs, the foundation must apply to the civil affairs bureau, finance bureau, and tax bureaus (state tax bureau and local tax bureau) at the provincial level, separately. Public welfare social organizations, other than foundations, established with the approval of a local civil affairs department at the county level or above may apply to financial, taxation, and civil affairs departments of provinces, autonomous regions, and municipalities directly under the Central Government, and cities specifically designated in the state plan. The civil affairs department shall be responsible for initial verification of the qualifications of public welfare social organizations and the finance department, and the taxation department shall jointly verify and confirm the qualification of pre-tax deduction of donations of public welfare social organizations. Qualified public welfare social organizations shall be publicized regularly by the MOF, the SAT, the Ministry of Civil affairs, and the finance, taxation, and civil affairs departments of provinces, autonomous regions, municipalities directly under the Central Government, and cities specifically designated in the state plan according to the above authority.[62]

Some social organizations are not required to register with government registration agencies, which will not meet item (1) of the criteria listed above. Those organizations include the social groups participating in the Chinese People's Political Consultative Conference, the social organizations approved by the State Council for no registration, and the social groups set by, and whose activities are limited within, government agencies, public organizations, and publicly funded institutions.[63] These social groups, if meeting certain conditions, may also apply for the qualification for receiving tax-deductible donations. For the social groups directly administrated by the central government

[62] Article 6 of Cai Shui [2008] No. 160.

[63] Article 3 of the Measures for Administration of Registration of Social Groups, Oder of the State Council [1998] No. 250, issued by the State Council on October 25, 1998.

agencies, the application should be made to the MOF and the SAT; for other social groups, the approval authorities are the finance and tax departments of provinces, autonomous regions, municipalities directly under the Central Government, and cities specifically designated in the state plan. These finance and tax authorities should publish approved lists for qualified social groups. Donations made through the approved social groups are deductible to enterprises subject to the 12 percent limitation.[64]

Donations other than those made to qualified public welfare social organizations and government offices are not deductible for CIT purposes.[65] Many public institutions, such as universities and hospitals, are not qualified public welfare social organizations; direct donations to those institutions by enterprises will not be deductible expenses for CIT purposes. Enterprises should make the donation through qualified public welfare social organizations and government offices in order to deduct donation expenses in computing taxable income. Similarly, enterprises should make donations for disaster relief, poverty relief, and other specific charitable objectives through qualified public welfare social organizations and government offices to ensure that the donation will be tax-deductible.

Qualified public welfare social organizations are authorized to issue special donation receipts printed by government finance departments.[66] The donation receipt should be issued based on the value of donated assets. If a donation is a monetary asset, the value should be the actual amount received. If a donation is a non-monetary asset, the value should be the fair market value of the asset at the time of donation. The donating enterprise should provide evidence of fair market value of the donated asset when making donation; without such evidence, public welfare social organizations and government offices cannot issue donation receipts.[67] Enterprises must have donation receipts to support a deduction for charitable donation.

The CIT Law, the CIT Implementation Rules, and the tax circulars issued thereunder do not specifically address the effect of donation of appreciated assets. Suppose an enterprise donates an asset with a tax basis of RMB100 and a fair market value of RMB300 to a qualified public welfare social organization. The enterprise should be allowed to deduct RMB300 as a donation expense in the current year if the amount is supported by a donation receipt issued by the public welfare social organization and within the limitation of 12 percent of total profit in the current year. However, a donation of a non-monetary asset is generally treated as a sale of the asset at its fair market value. As such, the enterprise should recognize RMB300 of revenue. After deducting RMB100 of cost

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[64] The Notice on the Issue Concerning Tax Deduction for Donations Made Through Public Welfare Social Groups, Cai Shui [2009] No. 124, issued by the MOF and the SAT on December 8, 2009 and effective on January 1, 2008.

[65] Article 10(5) of the CIT Law.

[66] Article 8 of Cai Shui [2008] No. 160.

[67] Article 9 of Cai Shui [2008] No. 160.

of the asset, the enterprise would have a net income of RMB200. Accordingly, the impact of the donation rule and deemed sale rule will actually allow the enterprise to have a net deduction of its tax basis in the asset, RMB100.

5.9 Sponsorship Expenses

Sponsorship expenses are not deductible in calculating taxable income.[68] Sponsorship expenses are various expenses incurred by an enterprise that are not connected with the production and business operations and that are not in the nature of advertising expenses.[69] The CIT Law and the CIT Implementation Rules do not provide further explanation or illustration of sponsorship expenses. The history of regulations and practice in the area suggests that the connection with production and business operations is narrowly interpreted. Sponsorship can include various activities such as funding culture, sports, and social events. It is no doubt that sponsoring enterprises intend to promote their business; more often, the sponsors are acknowledged by displaying their corporate logos, business names, or other images in the nature similar to advertisement. The tax authorities in practice do not recognize those activities are "connected with the production and business operations" of sponsoring enterprises because culture, sports, and other sponsored events are not their business. A similar provision on disallowing sponsorship expenses was provided in the EIT Regulations and the implementation rules of the CIT Regulations.[70] A tax circular issued under the old tax regulations suggests that sponsorship expenses cannot be treated as advertising expenses because the advertisements in sponsorship are not produced by licensed advertising companies and the sponsoring enterprises do not receive authorized advertising receipts.[71] The old tax circular is no longer valid after the effect of the CIT Law, but the principle most likely will continue to be followed by the tax authorities in implementing the CIT Law and the CIT Implementation Rules unless the MOF and the SAT address the matter in new tax circulars. Furthermore, the payments for sponsorship are not made to qualified public welfare social organizations and government offices; such expenses therefore are not qualified as deductible charitable contributions.

Certain sponsorship expenses can be deductible upon specific approval of the SAT. Such sponsorships have been the significant events supported by the Chinese Government.

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[68] Article 10(6) the CIT Law.

[69] Article 54 of the CIT Implementation Rules.

[70] Article 7 of the Provisional Regulations of Enterprise Income Tax and Article 17 of the Implementation Rules of the Provisional Regulations of Enterprise Income Tax, effective from January 1, 1994 to December 31, 2007.

[71] Article 41 of the Measures on Pre-tax Deductions of Enterprise Income, Guo Shui Fa [2000] No.84, issued by the SAT on May 16, 2000 and effective on January 1, 2000.

Fore example, various enterprises obtained such approvals for sponsoring the 2008 Beijing Olympics and the 2010 Shanghai World Expo.

5.10 Advertising Expenses

Qualified advertising expenses and promotional expenses that are incurred by an enterprise, except where the departments of the State Council in charge of finance and taxation prescribe otherwise, shall be deductible to the extent not exceeding 15 percent of the sales revenue of the year; any excess amount may be carried forward and deducted in succeeding tax years.[72] As an exception, the MOF and the SAT have provided special limitations for certain industries. During the period from January 1, 2008 to December 31, 2010, the enterprises engaging in cosmetic manufacturing, pharmaceutical manufacturing, and non-alcohol drink manufacturing may deduct advertising expenses and business promotion expenses up to 30 percent of the total sales revenue of the year; any excess amount may be carried forward and deducted in succeeding tax years.[73] The 30 percent limitation is applicable to a non-alcohol drink manufacturing enterprise that produces and sells the products in a specified area under a licensing agreement with a brand owner or brand management enterprise; the manufacturer/licensee can deduct the advertising and promotional expenses incurred by it in computing its taxable income. However, where the advertising and promotional expenses related to the brand are borne by the brand owner or brand management enterprise, as an alternative, the drink manufacturer/licensee can pass a portion or the full amount of the expenses to the brand owner or brand management enterprise, and the latter can deduct the actual expenses as selling expenses. The brand owner or brand management enterprise can exclude the advertising and promotional expenses incurred and charged by the licensed manufacturer from its advertising and promotional expenses in computing the limitation for the brand owner or brand management enterprise.[74] Enterprises in the tobacco industry are not allowed to deduct any advertising and promotional expenses for tobacco business for CIT purposes.[75]

The tax regulations have not provided a carryover period for excess advertising expenses; the excess amount can be carried over infinitely. Except otherwise provided, a deemed revenue should be recognized by an enterprise where it exchanges non-monetary assets or use of goods, assets, or services for donations, debt settlement, sponsorship,

[72] Article 44 of the CIT Implementation Rules.

[73] Article 1 of the Notice on Policies Concerning Corporate Income Tax Deduction on Advertising and Business Promotion Expenses for Certain Industries, Cai Shui [2009] No. 72, issued by the MOF and the SAT on July 31, 2009 and effective from January 1, 2008 to December 31, 2010.

[74] Article 2 of Cai Shui [2009] No. 72.

[75] Article 3 of Cai Shui [2009] No. 72.

fundraising, advertisement, samples, staff welfare or profit distributions.[76] Such deemed revenue should be included in the revenue base in computing the limitation for advertising expenses and promotional expenses.[77]

The SAT in a tax circular issued under the EIT Regulations sets up three criteria for qualified advertising expenses. First, the advertisements have been produced by a special institution approved by an authority responsible for industry and commerce. Second, the expenses have actually been paid and corresponding receipts have been obtained. Advertising receipts are special receipts printed or authorized by the tax authorities and only advertising enterprises that have been approved for the business can issue this type of receipt. Third, the advertisements have been broadcasted by certain media outlets.[78] The tax circular is technically no longer valid on and after January 1, 2008. However, as the rule does not contradict the principle of the CIT Law and the CIT Implementation Rules, the criteria most likely can be used as a reference in implementing the CIT Law unless the MOF and the SAT otherwise provide.

5.11 Foreign Exchange Losses

Foreign exchange losses that are incurred by an enterprise in currency transactions are deductible. If an enterprise has non-RMB denominated monetary assets and liabilities, foreign exchange losses that arise at the end of a tax year as a result of conversion of such assets and liabilities to RMB at the year-end medium spot exchange rate shall be deductible, except for the portion that has been recorded as the cost of assets or that is related to profit distributions to the shareholders.[79]

5.12 Dividends

Dividends, profit distributions, and other returns on equity investment paid to investors are not deductible.[80] The tax law and regulations do not define dividends for profit distribution purposes. According to the Company Law of the PRC, a company can only pay dividends to its shareholders when the company has accumulated retained earnings. The Company Law also requires that a company allocate a minimum of 10 percent of its current after-tax-profits to statutory reserve account before making profit distributions. However, if the balance of a company's statutory reserve reaches 50 percent of the

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[76] Article 25 of the CIT Implementation Rules.

[77] Notice on Tax Treatments of Certain Items in Implementation of Corporate Income Tax, Guo Shui Han [2009] No. 202, issued by the SAT on April 21, 2009.

[78] Article 41 of Guo Shui Fa [2000] No.84.

[79] Article 39 of the CIT Implementation Rules.

[80] Article 10 of the CIT Law.

company's registered capital, the company may elect not to allocate any profits to the reserve. If a company distributes dividends before the company has accumulated retained earnings or before allocating required statutory reserve, the shareholders must return the dividends to the company.[81] Similarly, PRC Sino-foreign Joint Venture Law and the Law of the PRC Concerning Wholly Foreign Wholly Enterprises also prohibit Chinese-foreign equity joint venture companies and wholly foreign owned enterprises from paying dividends without accumulated retained earnings or before making appropriate statutory reserves.[82] Distributions without accumulated retained earnings should be considered as a reduction of registered capital of an enterprise. For corporate law purposes, the approval of and/or registration with proper government agencies are required for the reduction of registered capital. For CIT purposes, any dividends or other types of profit distributions must be made out of after-tax profits and are not deductible in computing taxable income.

5.13 Penalties

Fines, penalties, and losses resulting from confiscation of property are not deductible.[83] These non-deductible items arise from the actions of the government because of violations of laws or regulations, including penalties imposed by any government offices in accordance with laws and regulations. Late payment interest charged on tax underpayment is not deductible either.[84]

5.14 Provisions

Unapproved provisions are not deductible.[85] These include various provisions for asset impairment, risk reserves, etc. that are not in compliance with the regulations prescribed by the MOF and the SAT.[86] An enterprise may be required to provide various provisions according to accounting standards. Those provisions generally are not deductible for CIT purposes unless specifically allowed under tax law and regulations. The followings are the major provisions that have been allowed under current tax regulations.

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[81] Article 167 of the Company Law of the PRC.

[82] Article 8 of PRC Sino-foreign Joint Venture Law; Article 58 of the Implantation Rules of the Law of the PRC Concerning Wholly Foreign Wholly Enterprises.

[83] Article 10(4) of the CIT Law.

[84] Article 10(3) of the CIT Law.

[85] Article 10(7) of the CIT Law.

[86] Article 55 of the CIT Implementation Rules.

5.14.1 PROVISIONS FOR LOAN LOSSES FOR FINANCIAL INSTITUTIONS

Financial instructions, such as banks, finance companies, and credit cooperatives that are licensed to conduct lending business are allowed to deduct certain provisions for loan losses. Such provisions can be provided for (1) loans, including mortgaged, pledged, or guaranteed loans, (2) the risk assets with loan characteristics, including bank card overdrafts, discounts, credit advance funds (such as bank acceptance bill advance, letter of credit advance, guaranty advance), import and export bills advance and inter-bank lending, and (3) on-lending of foreign loans with repayment obligation, including loans from international financial organizations, foreign buyer's credit, foreign government loans, unconditional loans from the Japanese International Cooperation Bank, and mixed loans from foreign governments.[87] The CIT deduction should be calculated using the following formula:[88]

$$
\begin{aligned}
&\text{Current year deduction for loan loss provision expenses} \\
&\quad = \text{Balance of above mentioned loan assets at the end of current year} \\
&\qquad \times 1\% - \text{Tax balance of the loan loss provision that has been deducted up to} \\
&\qquad\qquad \text{the end of last year}
\end{aligned}
$$

If the current year deductible provision calculated using this formula is negative, the taxable income of current year should be increased by the negative amount.[89] A financial enterprise cannot deduct loan loss provisions for entrusted loans, loans on behalf of others, investment in treasury bonds, dividends receivable, deposit reserves with the People's Bank of China, the debt and equity transferred from financial enterprises, financial discount receivables, receivables from the central bank, and other no-risk assets.[90] When a financial enterprise incurs qualified loan losses, the enterprise, after receiving an approval of tax authorities, should reduce a loan loss provision that has been deducted for CIT purposes; the portion exceeding the loan loss provision can be deducted in computing taxable income.[91]

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[87] Article 1 of the Notice on the Issues of Pre-tax Deduction for Provisions for Loan Losses of Finance Enterprises, Cai Shui [2009] No. 64, issued by the MOF and the SAT on April 30, 2009 and effective from January 1, 2008 to December 31, 2010.

[88] Article 2 of Cai Shui [2009] No. 64.

[89] Article 2 of Cai Shui [2009] No. 64.

[90] Article 3 of Cai Shui [2009] No. 64.

[91] Article 4 of Cai Shui [2009] No. 64.

Example

Bank ABC was established in 2008, and the balance of qualified assets and book loan loss provisions are as follows:

	Dec. 31, 2008	Dec. 31, 2009	Dec. 31, 2010
Loans and risk assets	1,000,000	3,000,000	2,800,000
Loan loss provision	*(15,000)*	*(30,000)*	*(29,000)*
Net	985,000	2,970,000	2,771,000

Deductible loan loss provisions for CIT are computed as follows:

For 2008: 1,000,000 x 1% – 0 = 10,000. The remaining book expense of 5,000 is not deductible for CIT purposes.

For 2009: 3,000,000 x 1% – 10,000 = 20,000. The book loan loss provision increased from 15,000 to 30,000 or a net increase of 15,000; the allowable tax loan loss provision increased from 10,000 to 30,000 or a net increase of 20,000. As such, additional tax deduction of 5,000 is allowed.

For 2010: 2,800,000 x 1% – 30,000 = –2,000. The book loan loss provision decreased from 30,000 to 29,000 or a net decrease of 1,000; the tax loan loss provision decreased from 30,000 to 28,000 or a net decrease of 2,000. As such, taxable income should be increased by 1,000 (the increase of 2,000 for tax less the increase of 1,000 for book).

Financial enterprises are allowed to deduct special loan loss provisions for agriculture-related loans and loans to medium- and small-sized enterprises. Agriculture-related loans are those recorded in agriculture-related loan statistics systems, including loans to farmers and rural enterprises and institutions.[92] The loans to medium- and small-sized enterprises are those made to an enterprise for which annual revenue and total assets cannot exceed RMB 200 million.[93] The allowable deduction of loss provision for those loans for CIT purposes is based on the loan risk classification according to Guidelines on Risk-Based Loan Classification issued by the People's Bank of China. According to the guidance, loans are classified into five categories based on risk level. They are:

(1) "Normal," a borrower can perform the contract and there is no sufficient reason to doubt that the principal and interest of the loan can be repaid in full and on time;

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[92] Article 2 of the Notice on Policy of Corporate Income Tax Deduction of Provision for Agriculture Related Loans and Loans to Medium and Small Size Enterprises, Cai Shui [2009] No. 99, issued by the MOF and the SAT on August 21, 2009 and effective from January 1, 2008 to December 31, 2010.

[93] Article 3 of Cai Shui [2009] No. 99.

(2) "Concerned," even though a borrower can repay the principal and interest of the loan now, there are some factors which may negatively affect the repayment thereof;
(3) "Substandard," there are some obvious problems in the repayment ability of a borrower, which cannot repay the principal and interest of the loan in full and on time just by using its normal operating revenues, and even though the guarantee is implemented, some losses will still be caused;
(4) "Doubtful," a borrower cannot pay the principal and interest of the loan in full, and even though the guarantee is implemented, great losses will still be caused; and
(5) "Losing," after taking all the possible measures and necessary legal procedures, the principal and interest of the loan cannot be recovered or just a small part thereof can be recovered.[94]

The special loan loss provision for agriculture-related loans and loans to medium- and small-sized enterprises that can be deducted for CIT purposes are as follows:[95]

Loan category	Deductible provision as percent of loan
Concerned	2%
Substandard	25%
Doubtful	50%
Losing	100%

When a financial enterprise incurs qualified losses for agriculture-related loans and loans to medium- and small-sized enterprises, the enterprise should reduce the special loan loss provision that has been deducted for CIT purpose first; the portion exceeding loan loss provision can be deducted in computing taxable income.[96]

5.14.2 RESERVES FOR INSTITUTIONS THAT PROVIDE CREDIT GUARANTEE FOR SMALL- AND MEDIUM-SIZED ENTERPRISES

An enterprise that is in the business of providing credit guarantee for small- and medium-sized enterprises can deduct guarantee claim reserve; such reserve for CIT purposes

[94] Article 4 of Guidelines on Risk-Based Loan Classification, issued by People's Bank of China on December 24, 2001.

[95] Article 1 of Cai Shui [2009] No. 99.

[96] Article 4 of Cai Shui [2009] No. 99.

cannot exceed 1 percent of the year-end balance of debts guaranteed by the enterprise.[97] When a guarantee enterprise incurs loss as a result of payment on behalf of guaranteed companies, the guarantee enterprise should first charge the loss against the guarantee claim reserves that have been deducted for CIT purposes, then against general risk provision allocated from after-tax-profits, and finally it should deduct the balance of loss on actual basis for CIT purposes.[98] A guarantee enterprise may also deduct unearned guarantee fee reserve not exceeding 50 percent of current year guarantee fee revenue; at the same time, the prior year balance of unearned guarantee fee reserve should be reversed into current year income.[99]

5.14.3 PROVISIONS FOR SECURITIES COMPANIES

Enterprises in the securities industry are allowed to deduct certain provisions for CIT purposes.

Exchange Risk Fund. Exchange Risk Fund is set up under Provisional Measures on Administration of Stock Exchange Risk Fund. Shanghai Stock Exchange and Shenzhen Stock Exchange are required to contribute 20 percent of the trading commission charged by the exchanges and 10 percent of the annual membership fee to the fund.[100] The exchanges can deduct such fund contributions for CIT purposes to the extent that the net fund assets are not more than RMB1 billion.[101]

Securities Settlement Risk Fund. Shanghai Branch and Shenzhen Branch of China Securities Depository and Clearing Corporation are required to pay the Securities Settlement Risk Fund an amount equal to 20 percent of revenue.[102] Such contributions to the fund are deductible by the contributing enterprise as long as the net fund assets are no more than RMB 3 billion.[103] Securities companies/settlement participants are required to pay to the Securities Settlement Risk Fund equal to 0.003 percent of trading amount

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[97] Article 1 of Notice on Corporate Income Tax Deduction of Provision for Institutions Providing Credit Guarantee for Small and Medium Size Enterprises, Cai Shui [2009] No. 62, issued by the MOF and the SAT on June 1, 2009 and effective from January 1, 2008 to December 31, 2010.

[98] Article 3 of Cai Shui [2009] No. 62.

[99] Article 2 of Cai Shui [2009] No. 62.

[100] Provisional Measures on Administration of Stock Exchange Risk Fund, Zheng Jian Fa [2000] No. 22, issued by China Securities Regulatory Commission on April 4, 2000 and invalidated and replaced by Measures on Administration of Stock Exchange Risk Fund, Zheng Jian Fa Lu Zi [2007] No. 5 issued by China Securities Regulatory Commission on March 6, 2007.

[101] Article 1(1) of Notice on Certain Issues Concerning the Deduction of Expense Previsions by Securities Industry for Corporate Income Tax Purposes, Cai Shui [2009] No. 33, issued by the MOF and the SAT on April 9, 2003 and effective from January 1, 2008 to December 31, 2010.

[102] Measures of Administration on Securities Settlement Risk Fund, Zheng Jian Fa [2006] No.65, issued by China Securities Regulatory Commission and the MOF on June 16, 2006.

[103] Article 1(2) of Cai Shui [2009] No. 33.

of RMB denominated ordinary shares and funds, 0.001 percent of the spot trading amount of treasury bonds, 0.00005 percent of the repo trading amount of one-day treasury bonds, 0.0001 percent of the repo trading amount of 2-day treasury bonds, 0.00015 percent of the repo trading amount of 3-day treasury bonds, 0.0002 percent of the repo trading amount of 4-day treasury bonds, 0.0005 percent of the repo trading amount of 7-day treasury bonds, 0.001 percent of the repo trading amount of 14-day treasury bonds, 0.002 percent of the repo trading amount of 28-day treasury bonds, 0.006 percent of the repo trading amount of 91-day treasury bonds, and 0.012 percent of the repo trading amount of 182-day treasury bonds;[104] securities companies are permitted to deduct such daily contributions for CIT purposes.[105]

Securities Investors Protection Fund. Shanghai Stock Exchange, Shenzhen Stock Exchange, and securities companies are required to contribute to Securities Investors Protection Fund.[106] After Stock Exchange Risk Fund reaches stipulated upper ceiling, the stock exchanges are required to contribute 20 percent of trading commission to Securities Investors Protection Fund. The stock exchanges can deduct such contributions for CIT purposes.[107] Securities companies are required to contribute 0.5 percent to 5 percent of business revenue to the fund; such contribution is deductible for CIT purposes.[108]

Futures Exchange Risk Fund. Shanghai Future Exchange, Dalian Commodity Exchange, Zhengzhou Commodity Exchange, and China Financial Future Exchange are required to contribute 20 percent of the trading commission collected from members to Futures Exchange Risk Fund; the exchanges can deduct such contribution within the balance prescribed by the relevant securities regulations for CIT purposes.[109]

Futures Company Risk Fund. Futures companies are required to contribute 5 percent of net commission (commission collected from customers less trading commission paid to the exchange) to Futures Company Risk Fund; such contribution is deductible for CIT purposes.[110]

Futures Investor Protection Fund. Shanghai Futures Exchange, Dalian Commodity Exchange, Zhengzhou Commodity Exchange, and China Financial Futures Exchange are required to contribute 3 percent of trading commission collected from members to

[104] Zheng Jian Fa [2006] No.65.

[105] Article 1(2) of Cai Shui [2009] No. 33.

[106] Article 12 of Measures for Administration of Securities Investor Protection Fund, Order of CSRC, MOF and PBOC [2005] No.27, issued by China Securities Regulatory Commission, the MOF, and the People's Bank of China on June 30, 2005 and effective on July 1, 2005

[107] Article 1(3) of Cai Shui [2009] No. 33.

[108] Article 1(3) of Cai Shui [2009] No. 33.

[109] Article 15 of Provisional Measures for Financial Administration of Commodity Futures Transactions, Cai Shang Zi [1997] No. 44, issued by the MOF on March 3, 1997; Article 2(1) of Cai Shui [2009] No. 33.

[110] Article 34 of Cai Shang Zi [1997] No. 44; Article 2(2) of Cai Shui [2009] No. 33.

Futures Investor Protection Fund. The exchanges can deduct such contribution within the balance prescribed by the relevant securities regulations for CIT purposes.[111] Future companies are required to contribute to the fund their commission income equal to 0.00005 percent to 0.0001 percent of trading volume; such contribution is deductible for CIT purposes.[112]

5.14.4 RESERVES FOR INSURANCE COMPANIES

Insurance companies are allowed to deduct various reserves in computing taxable income for CIT purpose. Many of deductible amounts are in line with those prescribed in insurance regulations.

Insurance Protection Fund. Insurance Protection Fund is a non-governmental industry risk relief fund that is created with payments made in accordance with insurance law and regulations and that is used for providing relief to policyholders and companies that take in transferred policies, or for dealing with risks in the insurance industry.[113] Insurance Protection Fund Company was set up by and is owned by the State; the company is responsible for the raising, management, and use of Insurance Protection Fund in accordance with the law.[114] An insurance company is required to make payments to the Insurance Protection Fund.[115] Insurance companies can deduct the actual payments to the Insurance Protection Fund in computing their taxable income with the following ceilings:[116]

Type of insurance business	Deduction ceiling
Non-investment property insurance	0.8% of the premium
Investment property insurance with guaranteed return	0.08% of revenue
Investment property insurance without guaranteed return	0.05% of revenue
Life insurance with guaranteed return	0.15% of revenue
Life insurance without guaranteed return	0.05% of revenue

(*Continued*)

[111] Article 9 of Tentative Measures for Administration of Futures Investors Protection Fund, CSRC Order [2007] No. 38, issued by China Securities Regulatory Commission on April 19, 2007 and effective on August 1, 2007; Article 2(3) of Cai Shui [2009] No. 33.

[112] Article 9 of CSRC Order [2007] No. 38; Article 2(3) of Cai Shui [2009] No. 33.

[113] Article 3 of Measures for the Administration of Insurance Protection Fund, Order of the China Insurance Regulatory Commission [2008] No. 2, issued by the China Insurance Regulatory Commission, the MOF and the People's Bank of China on September 11, 2008

[114] Article 6 of Measures for the Administration of Insurance Protection Fund.

[115] Article 14 of Measures for the Administration of Insurance Protection Fund.

[116] Article 1 of the Notice of Tax Deduction of Reserves for Insurance Companies, Cai Shui [2009] No. 48, issued by the MOF and the SAT on April 17, 2009 and effective from January 1, 2008 to December 31, 2010.

Type of insurance business	Deduction ceiling
Short-term health insurance	0.8% of premium
Long-term health insurance	0.15% of premium
Non-investment casualty insurance	0.8% of premium
Investment casualty insurance with guaranteed return	0.08% of revenue
Investment casualty insurance without guaranteed return	0.05% of revenue

The above ceilings are subject to further limitation. Once the balance of the Insurance Protection Fund of a property insurance company reaches 6 percent of the company's total assets or the balance of the Insurance Protection Fund of a life insurance company amounts to 1 percent of the company's total assets, any additional payments to the Insurance Protection Fund cannot be deducted for CIT purposes.[117]

The above ceilings are in line with the amount of mandatory contributions to the Insurance Protection Fund under insurance regulations.[118] The insurance regulations also permit an insurance company to stop making further contributions to the Insurance Protection Fund once its balance in the fund reaches 6 percent of its total assets for property insurance companies or 1 percent of its total assets for life insurance companies.[119] Accordingly, unless an insurance company contributes more than the legal required amount to the Insurance Protection Fund, all the contributions should be fully deductible for CIT purposes.

Other types of reserves. Insurance companies can deduct unearned premium reserves, life insurance reserves, and long-term health insurance reserves based on the amounts determined by the actuary or the professional firms that issue a special purpose audit report. Furthermore, an insurance company can deduct incurred and reported outstanding loss reserves in the amount of no more than 100 percent of the claims of the current period. Finally, an insurance company can deduct incurred but not reported outstanding loss reserves up to 8 percent of the actual claim settlement for the current period.[120] When an insurance company incurs claim settlement, it should first offset the payment against reserves; any amount in excess of the reserves can be deducted for CIT purposes.[121]

Additionally, some types of agricultural crop insurance are subsidized by the central government and local governments. An insurance company that operates those types of subsidized crop insurance can deduct catastrophic risk reserve in the amount of no more

[117] Article 2 of Cai Shui [2009] No. 48.

[118] Article 14 of Measures for the Administration of Insurance Protection Fund.

[119] Article 15 of Measures for the Administration of Insurance Protection Fund.

[120] Article 3 of Cai Shui [2009] No. 48.

[121] Article 4 of Cai Shui [2009] No. 48.

than 25 percent of premium received for those types of insurance. The current year deductible amount is computed based on the following formula:

$$\text{Current year deduction} = \text{Current year premium income} \times 25\% - \text{Balance of pre-tax catastrophic risk reserve as of the end of last year}$$

If the amount calculated by the above formula is negative, current year taxable income should be adjusted (increased) accordingly. The policy is applicable for the period from January 1, 2008 through December 31, 2010.[122]

5.15 Deduction of Reinsurance Claims

A reinsurance company is allowed to deduct a reinsurance claim for the tax year incurred but only if the reinsurance company receives the settlement request of insurance company before the reinsurance company files its annual CIT return for the year.[123] As an enterprise generally is required to file its annual CIT return on or before May 31 after a tax year, a reinsurance company can deduct the claim if it receives the settlement request from the insurance company before May 31 of the following year; if the reinsurance company receives the settlement request after the date, it can deduct the claim in the year in which it receives the request.

5.16 Commission Expenses

An enterprise may deduct commission expenses or brokerage fees paid in relation to the production or business operations of the enterprise. However, such deduction is subject to limitations. Such limitation for a property insurance company is 15 percent of total premium income net of cash surrender value. The limitation for a life insurance company is 10 percent of total premium income net of cash surrender value. An enterprise other than an insurance company can deduct commission expenses up to 5 percent of revenue prescribed by the commission service agreement between the enterprise and a licensed commission agency organization or an individual. Any amount in excess of the

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[122] The Notice on Deduction of Agriculture Catastrophe Risk Reserve for Corporation Income Tax Purposes for Insurance Companies, Cai Shui [2009] No. 110, issued by the MOF and the SAT on August 21, 2009 and effective from January 1, 2008 to December 31, 2010.

[123] Notice of Deduction of Reinsurance Claims for Corporate Income Tax Purposes, Guo Shui Han [2009] No. 313, issued by the SAT on June 4, 2009.

limitations cannot be deductible for CIT purposes.[124] An enterprise should pay the commission through a bank transfer. If an enterprise makes a commission payment in cash to a commission agent other than an individual, the enterprise cannot deduct such cash payment expense for CIT purposes. Furthermore, an enterprise cannot deduct commission expenses paid to underwriting firms for issuing securities.[125] An enterprise should properly record commission expenses. It should record income and commission expenses separately and cannot directly offset commission expenses against income.[126] The commission expenses recorded in fixed assets and intangible assets should be depreciated or amortized and cannot be deducted in current period.[127]

5.17 Asset Losses

The deductions of asset losses by enterprises for CIT purposes are subject to specific requirements and procedures. The MOF and the SAT issued a notice of the CIT deduction policy.[128] The SAT further provides detailed implementation rules based on the policy.[129] The "assets" refers to the assets possessed or controlled by an enterprise, used for operation and management and in connection with the gain of taxable revenue, including (1) monetary assets such as cash, bank deposits, receivables, and advance payment, (2) non-monetary assets such as inventories, fixed assets, projects in construction, and productive biological assets, (3) debt investment, and (4) equity investment.[130]

5.17.1 Time of and Approval for Deduction

Subject to specific requirements and procedures, the loss of those assets generally can only be deducted by an enterprise in the year when such loss occurs, and may not be deducted in the years prior or subsequent to the loss period. If an enterprise fails to claim a loss deduction in the year when loss occurs because the loss cannot be accurately calculated for various reasons, the enterprise may subsequently obtain an approval of the tax authorities for adjustment to the expenses for the year in which the loss occurs.[131] If such

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[124] Article 1 of Notice of Policy of Deduction of Commission Expenses for Corporate Income Tax Purposes, Cai Shui [2009] No. 29, issued by the MOF and the SAT on March 19, 2009 and effective on March 19, 2009.

[125] Article 2 of Cai Shui [2009] No. 29.

[126] Article 5 of Cai Shui [2009] No. 29.

[127] Article 4 Cai Shui [2009] No. 29.

[128] Notice of Policy of Deduction of Asset Losses for Corporate Income Tax Purposes, Cai Shui [2009] No. 57, issued by the MOF and the SAT on April 16, 2009 and effective on January 1, 2008

[129] Measures for Administration of the Deduction of Asset Losses for Corporate Income Tax Purposes, Guo Shui Fa [2009] No. 88, issued by the SAT on May 4, 2009 and effective on January 1, 2008

[130] Article 2 of Guo Shui Fa [2009] No. 88.

[131] Article 3 of Guo Shui Fa [2009] No. 88.

adjustment to prior year expenses results in an overpayment of CIT for the prior year, such overpayment can be credited to offset the tax payable for the year in which the approval is obtained. If the overpayment is greater than the amount of tax payable for the approval year, the excess amount can be credited to subsequent years. If the prior year adjustment results in loss for the prior year, the enterprise should first adjust its loss for the year and then carry forward losses in accordance with the CIT Law. This rule on timing of deduction of prior year losses also applies to the losses incurred in the years prior to the implementation of the CIT Law where the losses were qualified for deduction under the old tax law.[132]

Asset losses can be classified as self-claimed loss and approved loss. A self-claimed loss is the actual asset loss that may be calculated and deducted on tax returns by an enterprise itself without an approval of the tax authorities; an approved loss is the asset loss of which the deduction shall be subject to the examination and approval by tax authorities.[133] The following asset losses are self-claimed losses:[134]

(1) the asset losses resulted from sales, transfers, and disposal of fixed assets, productive biological assets, and inventory in regular operation and management activities by an enterprise;
(2) the losses resulted from normal wear and tear of inventories;
(3) the losses resulted from normal abandonment or disposal of fixed assets that reach or exceed the useful life of the assets;
(4) the asset losses resulted from the natural death of productive biological assets of an enterprise that reach or exceed the life of use;
(5) the losses resulted from the transactions of bonds, stocks, funds and financial derivative products through securities exchanges and inter-bank markets; and
(6) other asset losses that are determined by the SAT and are not subject to examination and approval by tax authorities.

The asset losses other than those listed above are approved losses; the deductions of which are subject to the examination and approval of the tax authorities. If an enterprise is unable to ascertain whether its losses are self-claimed or approved losses, the enterprise may apply for examination and approval to the tax authorities.[135]

If an enterprise claims a deduction for an approved loss, the enterprise must submit application for deduction to appropriate tax authority. The tax authority will examine

[132] The Notice on the Issue Concerning Corporate Income Tax Treatment of Prior Asset Losses that Have not Been Deducted, Guo Shui Han [2009] No. 772, issued by the SAT on December 31, 2009.

[133] Article 5 of Guo Shui Fa [2009] No. 88.

[134] Article 5 of Guo Shui Fa [2009] No. 88.

[135] Article 5 of Guo Shui Fa [2009] No. 88.

the evidence provided and determine whether the claim satisfies the conditions prescribed by the tax regulations. A taxpayer can apply for the approval of deduction of losses to the approval authority directly, rather than approval level by level. The tax authorities are authorized to approve deduction of losses based on the following criteria:[136]

(1) If the asset loss of an enterprise is resulted from any decision of the State Council, after the specific issues concerning examination and approval on asset losses are stipulated by the SAT, the application shall be submitted to provincial tax authorities for examination and approval.
(2) For other asset losses, the provincial tax authorities where an enterprise is located should determine the level of approval authority based on such factors as amount of loss and the areas of evidence. The enterprise should submit the application to the designated tax authority.
(3) The losses of bundled assets of an enterprise shall be examined and approved by the tax authority of the place where the headquarters of such enterprise is located.

If the approval authority is a provincial tax authority, the decision should be made within 30 working days after acceptance of an application. If the approval authority is a tax bureau below provincial level, the time limit for examination and approval should be prescribed by the provincial tax authorities; however, such the time for examination and approval should not be longer than 30 working days. Where the taxation authorities cannot complete the review within the prescribed period because of complex situations, upon the approval of the principals of the taxation authorities at the same level, the term can be extended up to 30 days. At the same time, the applicant shall be informed of the reason for such extension.[137] An enterprise can submit an application any time, but should not be later than the 45th day after the end of a year. For special reasons, an enterprise may obtain the consent from the tax authority responsible for the examination and approval for an extension of time.[138]

5.17.2 EVIDENCE OF ASSET LOSSES

To deduct self-claimed losses, an enterprise should, in accordance with the requirements of internal control system of the enterprise, confirm the asset losses, and keep such relevant evidence as asset accounting materials, original credentials, and certificates of

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[136] Article 6 of Guo Shui Fa [2009] No. 88.
[137] Article 7 of Guo Shui Fa [2009] No. 88.
[138] Article 8 of Guo Shui Fa [2009] No. 88.

internal examination and approval for future inspection by the tax authorities. To apply for an approval of deduction of approved losses, an enterprise shall provide lawful evidence proving the asset losses are actually generated, including external evidence with legal force and internal evidence of specific events.[139] The external evidence with legal force refer to the written documents with legal force in connection with the asset losses of the enterprises produced by judicial authorities, administrative authorities, and professional technical verification authorities, mainly including:[140]

(1) Judgments or rulings of judicial authorities;
(2) Certificates and replies of case registration and closing of public security authorities;
(3) Certificates for cancellation, revocation, and suspension of business registration produced by industrial and commercial authorities;
(4) Bankruptcy and liquidation announcement or settlement and compensation documents of the enterprise;
(5) Official documents of administrative authorities;
(6) Verification reports of the State and the authorized professional technical verification authorities;
(7) Economic verification certificates produced by the intermediate agencies with legal qualification;
(8) Arbitration documents of economic arbitration agencies;
(9) Insurance investigation documents and insurance settlement documents produced by insurance companies against insured assets; and
(10) Other evidence in conformity with legal requirements.

The internal evidence of specific events refers to the internal certificates or responsibility statements on destruction or damage, abandonment, inventory losses, deaths, and deterioration of the assets of an enterprise with a well-established accounting system and internal control system, mainly including:[141]

(1) Relevant accounting books and records;
(2) Assets inventory sheets;
(3) Business contracts;
(4) Verification documents or materials of internal technical verification departments of the enterprises (in case of the items of asset losses of a large amount or

[139] Article 9 of Guo Shui Fa [2009] No. 88.
[140] Article 11 of Guo Shui Fa [2009] No. 88.
[141] Article 12 of Guo Shui Fa [2009] No. 88.

significant impact, industrial experts shall be engaged to participate in the verification and discussion);
(5) Internal examination and approval documents and explanations for relevant events;
(6) Explanations for responsibility determination and compensation of responsible persons for the losses caused by mismanagement; and
(7) Statements of legal representative, business in charge, and finance in charge of the enterprise for undertaking legal liabilities for the authenticity of specific events.

5.17.3 RECOGNITION OF MONETARY ASSET LOSSES

The monetary asset losses of an enterprise include cash losses, bank deposit losses, and receivable (advance payment) losses.[142] The SAT provides guidance on evidence required for recognition monetary asset losses on cash and non-cash assets, respectively.

Cash loss. If an enterprise incurs cash loss, the enterprise can recognize the amount of loss net of any compensation made by the responsible person. The enterprise should provide the following evidence:[143]

(1) Cash count sheet verified by the cash keeper (including the relevant records since the base date);
(2) An explanation and relevant verification documents of the cash keeper on cash shortage;
(3) The explanations for the determination of responsibility and compensation of the responsible person because of misconduct or mismanagement; and
(4) The criminal case materials provided by judicial authorities (in cases where a crime is involved).

Loss of deposits. If an enterprise deposits monetary funds with an institution with a legal license to receive deposits and actually cannot recover the funds because of bankruptcy or liquidation of such institution in accordance with applicable laws or the suspension or close of business under the order of the government, the enterprise can recognize deposit loss. The deposit loss shall be evidenced by the following evidence:[144]

(1) Original receipts of bank deposits;
(2) Legal documents on bankruptcy or liquidation of the depository institution;

[142] Article 13 of Guo Shui Fa [2009] No. 88.
[143] Article 14 of Guo Shui Fa [2009] No. 88.
[144] Article 15 of Guo Shui Fa [2009] No. 88.

(3) External evidence such as the orders of the *government* for suspension and close of business, and
(4) Documents on the remaining assets distribution upon liquidation of the depository institution.

Bad debt loss (other than loan loss). An enterprise may deduct bad debt expense for unrecoverable receivables (other than loans) and advance payment if any of the following conditions are met:[145]

(1) The debtor has declared, in accordance with law, bankruptcy, the close of business, or dissolution or debtor's business license has been revoked or de-registered and the liquidating assets are not sufficient to pay the debt;
(2) The debtor is dead or declared missing or dead and his or her assets or estate is not sufficient to pay the debt;
(3) The debt is overdue for more than three years and there is sufficient evidence that the debtor is not able to pay the debt;
(4) The enterprise is unable to seek recovery of debt after failing to reach a debt restructuring agreement with the debtor or the approval of court on bankruptcy reorganization plan;
(5) The enterprise cannot recover the debt as a result of force majeure events such as natural disasters or wars; and
(6) Other conditions provided by the MOF and the SAT.

An enterprise must obtain an approval of the tax authority before deducting receivable (advance payment) losses. The enterprise should provide the following evidence in its application for the bad debt deduction:[146]

(1) The notice of court on bankruptcy and liquidation documents in bankruptcy proceedings;
(2) The judgment or ruling of court denying the claim of debt recovery by the enterprise or the ruling of court stopping the enforcement of a successful judgment;
(3) The certificate of industrial and commercial authorities for cancellation or revocation of business registration of the debtor;
(4) The documents showing administrative decisions of governmental authorities on cancellation and order of closing business of debtor;
(5) The death or missing certificate issued by public security authorities;

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[145] Article 4 of Cai Shui [2009] No. 57.

[146] Article 16 of Guo Shui Fa [2009] No. 88.

(6) The clear evidence of inability to pay off debts that have been due for more than three years. The enterprise should maintain the records of payment demands to and discussions with the debtor. The enterprise should confirm that the debtor's liabilities are greater than its assets and debtor had losses for three consecutive years or ceases to business for more than three years. The enterprise also must confirm that there is no business transaction with the debtor for three years;[147]
(7) The reorganization agreement with debtor and relevant evidence thereof; and
(8) Other relevant evidence.

Of the unrecoverable receivables, if the amount of an item is so small that a successful recovery would not be sufficient to cover the cost for recovery efforts, an enterprise can make a specific explanation rather than providing the evidence listed above.[148]

On and after January 1, 2009, enterprises in the telecommunication industry may deduct bad debt for telephone fee receivables overdue for more than one year if each relevant single customer's fee is small. The general evidence requirement for bad debt deduction as discussed above does not apply; the telecom enterprise need only provide an explanation.[149]

5.17.4 RECOGNITION OF NON-MONETARY ASSET LOSSES

The non-monetary asset losses of enterprises include losses of inventories, fixed assets, construction in progress, and productive biological assets.[150]

Loss on inventory count. If an enterprise incurs a loss on inventory count, the enterprise can recognize the amount of loss net of any compensation made by the person responsible for the loss. The enterprise should provide the following evidence to prove the inventory losses:[151]

(1) Inventory count sheets;
(2) The description of losses prepared by an inventory custodian;
(3) The basis for value determination of the inventories (including relevant warehousing documents, purchase invoice price of identical or similar inventories or other bases for determination); and

[147] Article 18 of Guo Shui Fa [2009] No. 88.
[148] Article 17 of Guo Shui Fa [2009] No. 88.
[149] Notice of the Issue of Bad Debt Deduction for Telecomm Enterprises, Guo Shui Han [2010] No. 196, issued by the SAT on May 12, 2010.
[150] Article 19 of Guo Shui Fa [2009] No. 88.
[151] Article 20 of Guo Shui Fa [2009] No. 88.

(4) The description of the determination of relevant liabilities and compensation by a liable person within an enterprise, and documents of internal review and approval.

Loss on inventory scrap, damage and deterioration. If an enterprise incurs a loss on inventory scrap, damage, or deterioration, the enterprise can recognize the amount of loss, which is the tax basis of inventory less residual value, insurance payment, and any payment from a responsible person. The enterprise should provide the following evidence to prove the inventory losses:[152]

(1) The certificate of technical assessment produced by relevant technical departments within an enterprise where the single item or batch of inventories involves small amounts (accounting for less than 10 percent of the same category of inventories, or a decrease in the taxable income or increase in losses of less than 10 percent or less than RMB100,000);
(2) If the amount exceeds the above amount, the enterprise should provide the reports issued by professional technical assessment organizations or intermediaries with legal qualifications;
(3) The description of claim settlement by insurance companies where insurance claims are involved;
(4) The description of inventory scrap, damage, or deterioration prepared by the enterprise and documents showing the examination and approval within the enterprise;
(5) The description of residual value; and
(6) The description of the determination of relevant liabilities and indemnities and documents showing internal review and approval.

Loss on inventory stolen. If an enterprise incurs a loss on inventory stolen, the enterprise can recognize the amount of loss, which is the tax basis of stolen inventory less insurance payment and any payment from responsible person. The enterprise should provide the following evidence to prove the inventory losses:[153]

(1) The relevant records kept by public security authorities on case report and supporting documents for initiating, investigating, and closing cases;
(2) The description of the determination of a responsible person and compensation; and

[152] Article 21 of Guo Shui Fa [2009] No. 88.
[153] Article 22 of Guo Shui Fa [2009] No. 88.

(3) The description of claim settlement by insurance companies where insurance claims are involved.

Loss of fixed assets count. If an enterprise incurs a loss as a result of a fixed assets count or of fixed assets missing, the enterprise can recognize the amount of loss, which is the tax basis of the fixed assets less any payment from responsible person. The enterprise should provide the following evidence to prove the fixed asset losses:[154]

(1) Fixed assets inventory sheets;
(2) The description of losses or missing fixed assets. If the single item or batch of missing fixed assets is in a large amount (accounting for at least 10 percent of the same category of fixed assets, or a decrease in the taxable income or increase in losses of 10 percent or more, or RMB100,000 or more), the enterprise shall explain item by item, and present economic assessment certificates produced by intermediaries with legal qualifications; and
(3) The documents of the determination of relevant liabilities within the enterprise and documents of internal approval.

Loss of fixed assets scrap and damage. If an enterprise incurs a loss as a result of fixed assets scrap and damage, the enterprise can recognize the amount of loss, which is the tax basis of missed assets less residual value, insurance payment and any payment from responsible person. The enterprise should provide the following evidence to prove the fixed asset losses:[155]

(1) Assessment certificates produced by relevant internal departments of an enterprise;
(2) If the scrap and damage of fixed assets are small amounts (accounting for less than 10 percent of the same category of fixed assets, or decrease in the taxable income or increase in losses of less than 10 percent, or less than RMB100,000) of single items or batches, the enterprise may explain item by item, and present technical assessment certificates produced by relevant internal technical departments. If the amount exceeds the above criteria, the enterprise shall explain item by item, and present assessment reports produced of professional technical assessment institutions, and may also attach assessment certificates produced by intermediaries.
(3) Where the damage or scrap of fixed assets is caused by force majeure, such as a natural disaster, assessment reports produced by relevant governmental

[154] Article 23 of Guo Shui Fa [2009] No. 88.
[155] Article 24 of Guo Shui Fa [2009] No. 88.

functional departments shall be presented, for instance, damage proof issued by fire department, the accident report and certificate of vehicle damage issued by public security authorities, the certificate of house demolition issued by housing administration, and the inspection reports issued by public safety inspection agencies such as boiler and elevator inspection offices;

(4) The description of fixed assets scrap and damage and the documents of internal review and approval of the enterprise; and
(5) The description of claim settlement by insurance companies where insurance claims are involved.

Loss of fixed assets stolen. If an enterprise incurs a loss on fixed assets stolen, the enterprise can recognize the amount of loss, which is the tax basis of stolen assets less insurance payment and any payment from responsible person. The enterprise should provide the following evidence to prove the asset losses:[156]

(1) The relevant records kept by public security authorities on case report and supporting documents for initiating, investigating, and closing cases;
(2) The description of the determination of a responsible person and compensation; and
(3) The description of claim settlement by insurance companies where insurance claims are involved.

Loss of construction in progress. If an enterprise ceases or abandons a project in construction, the enterprise can recognize the loss of abandonment and demolition, which is the tax basis of construction in progress less residual value. The enterprise should provide the following evidence to prove the asset losses:[157]

(1) The document issued by the State that ordered the stopping of the project;
(2) The documents of project cessation and demolition issued by relevant government authorities;
(3) The assessment opinion on the abandonment of a project in construction and the documents of review and approval; if the abandoned project is a large amount item, an assessment report issued by a professional technical assessment agency is required; and
(4) The basis for the determination of actual costs of the project.

[156] Article 25 of Guo Shui Fa [2009] No. 88.
[157] Article 26 of Guo Shui Fa [2009] No. 88.

If an enterprise incurs losses of projects in construction caused by a natural disaster or an accident, the enterprise can recognize the amount of loss, which is the tax basis of the project less residual value, insurance payment and any payment from responsible person. The enterprise should provide the following evidence to prove the asset losses:[158]

(1) The description of claim settlement where insurance claims are involved; and
(2) The description of the relevant liabilities and compensation of responsible persons determined by the enterprise and the document of internal approval.

The CIT treatment of losses of construction materials for construction in progress is the same as that of inventory loss.[159]

Loss of productive biological assets. If an enterprise incurs a loss on productive biological assets count, the enterprise can recognize the amount of loss net of any compensation made by the person responsible for the loss. The enterprise should provide the following evidence to prove the asset losses:[160]

(1) Productive biological assets inventory sheets;
(2) The description of losses. If the amount of loss is large (accounting for more than 10 percent of the same category of assets, or decrease in the taxable income or increase in losses of more than 10 percent, or more than RMB100,000) of a single item or batch, the enterprise should explain item by item; and
(3) The description of the determination of relevant liabilities and documents of internal review and approval.

If an enterprise incurs a loss on productive biological assets resulting from plant diseases, pests, epidemics and death, the enterprise can recognize the amount of loss, which is the tax basis of assets less residual value, insurance payment, and any payment from a responsible person. The enterprise should provide the following evidence to prove the asset losses:[161]

(1) The assessment certificate produced by relevant internal departments of the enterprise;
(2) In the case where a single item or batch is relatively large (accounting for more than 10 percent of the same category of assets, or a decrease in the

[158] Article 27 of Guo Shui Fa [2009] No. 88.
[159] Article 28 of Guo Shui Fa [2009] No. 88.
[160] Article 29 of Guo Shui Fa [2009] No. 88.
[161] Article 30 of Guo Shui Fa [2009] No. 88.

taxable income or increase in losses of more than 10 percent, or more than RMB100,000), the itemized explanation made by the enterprise concerning the plant diseases, pests, epidemics, and death of productive biological assets, and the assessment reports produced by professional technical assessment departments;

(3) The assessment report produced by relevant functional departments in case of plant diseases, pests, epidemics, and death of productive biological assets caused by force majeure, for instance, the certificate of forest diseases and pests issued by government authority in charge of the forestry industry, the epidemics certificate issued by health and epidemic prevention authorities, the damage proof issued by the fire department, the accident report issued by public security authorities;

(4) Description of plant diseases, pests, epidemics, and death of productive biological assets of an enterprise and documents of internal review and approval; and

(5) The descriptions of claim settlements by insurance companies where insurance claims are involved.

If an enterprise incurs a loss on productive biological assets because the inventories were felled, stolen or missing, the enterprise can recognize the amount of loss, which is the tax basis of assets less insurance payment and any payment from responsible person. The enterprise should provide the following evidence to prove the asset losses:[162]

(1) The relevant records kept by public security authorities on the case report and supporting documents for initiating, investigating, and closing cases after productive biological assets are stolen;

(2) The description of the determination of a responsible person and compensation; and

(3) The description of claim settlement by insurance companies where insurance claims are involved.

Loss on auction of assets. If an enterprise fails to redeem the mortgaged assets on time, and causes the same to be auctioned or sold off, the enterprise can recognize the asset loss in the amount of tax basis in the assets in excess of auction proceeds. The claim of loss must be supported by the certificate of auction or disposition.[163]

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[162] Article 31 of Guo Shui Fa [2009] No. 88.

[163] Article 32 of Guo Shui Fa [2009] No. 88.

5.17.5 RECOGNITION OF DEBT INVESTMENT LOSSES

Loss on bad loans. An enterprise may deduct loan losses for CIT purposes if any of the following conditions are met:

(1) The debtor and the guarantor declare bankruptcy, closure, dissolution, or cancellation and terminate their legal person status in accordance with applicable law, and the enterprise has sought recovery but is unable to recover the debt from the debtor and the guarantor. In such case, the enterprise should provide bankruptcy, closure or dissolution certificates or cancellation documents of the debtor and the guarantor and the certificates of business de-registration and assets liquidation issued by administrative departments of industry and commerce at the county level or above.[164]

(2) The debtor is deceased, or declared missing or dead in accordance with applicable law and the enterprise has sought recovery but unable to recover the debt from the debtor's assets or estate and the guarantor. In such case, the enterprise should provide the certificate of decease or missing of the debtor and liquidation certificate of assets or estate.[165]

(3) The debtor suffers significant losses as a result of a severe natural disaster or accident and is not able to repay the debt because of no or insufficient insurance coverage; the enterprise has sought recovery but unable to recover the debt from the debtor's liquidating assets and the guarantor. In such case, the enterprise should provide the proof that the debtor has suffered severe natural disaster or accident, the certificate of insurance settlement, and the certificate of asset liquidation.[166]

(4) The debtor and the guarantor have not declared bankruptcy, closure, dissolution, or cancellation in accordance with applicable law, but they have completely discontinued operations and their business licenses have been canceled by administrative departments of industry and commerce at county level or above in accordance with applicable law; the enterprise has sought recovery but is unable to recover the debt from the debtor and the guarantor. In such case, the enterprise should provide the certificates of cancellation or revocation of business licenses of the debtor and the guarantor and the certificate of assets liquidation.[167]

(5) The debtor and the guarantor have not declared bankruptcy, closure, dissolution, or cancellation in accordance with applicable law, but they have completely

[164] Article 5(1) of Cai Shui [2009] No.57; Article 34 (1) of Guo Shui Fa [2009] No. 88.

[165] Article 5(2) of Cai Shui [2009] No.57; Article 34 (2) of Guo Shui Fa [2009] No. 88.

[166] Article 5(3) of Cai Shui [2009] No.57; Article 34 (3) of Guo Shui Fa [2009] No. 88.

[167] Article 5(1) of Cai Shui [2009] No.57; Article 34 (4) of Guo Shui Fa [2009] No. 88.

discontinued operations or are missing and have not attended annual industrial and commercial inspection for two consecutive years; the enterprise has sought recovery but is unable to recover the debt from the debtor and the guarantor. In such case, the enterprise should provide the certificates of inquiry and assets liquidation issued by administrative departments of industry and commerce at county level and above.[168]

(6) The debtor has received criminal penalties, the debtor's assets are insufficient to repay the debt, and there are no other obligators; the enterprise has sought recovery but is unable to recover the debt. In such case, the enterprise should provide the proof of the court decision and assets liquidation.[169]

(7) The enterprise brought and won a legal action against the debtor and the guarantor, but the enterprise is unable to recover the debt due to the insufficient assets of the debtor and the guarantor to enforce the judgment and the court has ruled a termination of judgment execution. In such case, the enterprise should provide the proof of the court decision and assets liquidation. Furthermore, where the execution of judgment is terminated, the enterprise should provide an estimate of fair market value of assets of the debtor and the guarantor. If the value of assets is insufficient to pay off the claims with priority higher than the enterprise's debt in accordance with Bankruptcy Law, the enterprise may provide specific explanation and claim a bad debt deduction of the full amount of debt; if there is a balance after paying all the priority claims and such remainder is insufficient to pay off the debt, the permissible bad debt deduction should be determined based on the ratio of the debts. Where the enterprise has more than one debt claim against one debtor, the amount of debt losses should be determined in the principle of analogy.[170]

(8) The enterprise brings a legal action against the debtor and the guarantor, but the court dismisses the action, or rules to release (or partially release) the debtor's debt because the debtor and the guarantor can on longer be qualified defendants and there are no other obligators, or the court does not to accept or support such action because of loss of written evidence of debt or statutes of limitation; the enterprise has sought recovery but is unable to recover the debt. In such case, the enterprise should provide the proof of the decision of the court to reject, not accept, or not support the action or claim, or a judgment, ruling, or civil mediation agreement that releases the debtor's obligation.[171]

[168] Article 34 (5) of Guo Shui Fa [2009] No. 88.

[169] Article 5(4) of Cai Shui [2009] No.57; Article 34 (6) of Guo Shui Fa [2009] No. 88.

[170] Article 5(5) of Cai Shui [2009] No.57; Article 34 (7) of Guo Shui Fa [2009] No. 88.

[171] Article 34 (8) of Guo Shui Fa [2009] No. 88.

(9) Where (1) the debtor cannot repay matured debts for any reason referred to in Items 1 to 8 above, (2) the enterprise obtains debtor's assets as repayment of debt in accordance with applicable law, (3) the value of assets is less than the amount of debt, and (4) the enterprise has sought recovery but is unable to recover the unpaid amount, the enterprise may claim a deduction for such amount. In such case, the enterprise should provide the proof of the acceptance of repayment debt in assets, the amount of debt paid in assets, and relevant evidence as required in Items 1 to 8.[172]

(10) The debtor cannot repay the matured debt to an enterprise for any reason referred to in Items 1 to 9 and the enterprise suffers a loss arising from debt restructuring in accordance with applicable law. In such case, the enterprise should provide the proof of its loss and the plan of debt restructuring that is legally enforceable.[173]

(11) Where an enterprise sells loans by means of package sale, public auction, or biding upon government approval, the enterprise may claim bad debt loss for the tax basis in the loans in excess of sale price. The enterprise should provide the plan of assets disposal, sales, and transfer agreements, the proof of transaction and the reception of payments, and a detailed list of book value of the assets.[174]

(12) Where the losses are resulted from the lack of internal control system, the irregularity of operation procedures, or the lack of clear policy guidance and implementation rules in business innovation, for the amount to be assumed by the enterprise, the enterprise should provide the documents evidencing the reasons for losses or the certificate of regulatory agency stating the nature of losses and specific explanation of losses.[175]

(13) If an enterprise suffers losses because of a criminal case, for the amount to be assumed by the enterprise or that cannot be recovered over two years after a formal investigation by public security authorities, the enterprise should provide the document evidencing the reasons for losses and case status report issued by the public security authorities or prosecutors office or a judicial judgment.[176]

(14) In case of balance of a mortgage or pledged loan of RMB5 million or less made by a financial enterprise or that of RMB500,000 or less made by a rural credit cooperative or a village bank, the enterprise can claim a deduction for

[172] Article 34 (9) of Guo Shui Fa [2009] No. 88.

[173] Article 5(6) of Cai Shui [2009] No.57; Article 34 (10) of Guo Shui Fa [2009] No. 88.

[174] Article 34 (11) of Guo Shui Fa [2009] No. 88.

[175] Article 34 (12) of Guo Shui Fa [2009] No. 88.

[176] Article 34 (13) of Guo Shui Fa [2009] No. 88.

the loss if it is not able to recover the loan after seeking recovery for more than one year. In such case, the enterprise should provide document proving the reasons for losses, the detailed records of loan recovery activities (including original records of telephone, mail, or personal visits with confirmation and signatures of the person handling the case and the person in charge).[177]

(15) An enterprise may claim a deduction of loss for the loan write-off specifically approved by the State Council. The enterprise should provide the approval document issued by the State Council or by relevant departments of the State Council upon the consent of the State Council.[178]

In China, an enterprise generally can only make loans if its business scope includes such business activity. An enterprise that is not in the financing business may make loans to other entities through entrusted loan arrangement where the lender makes loans through a bank. In such an arrangement, the bank will charge a service fee and will not assume any liability on the loan.[179] The above bad debt loss qualification standards and procedures should also apply to non-financial enterprise lenders with respect to entrusted loans.[180]

Credit card losses. If the overdraft of bank cards and other relevant receivables that have been included in the taxable incomes of a financial enterprise meet the conditions for bad debts, the enterprise can recognize the losses based on the following evidence:[181]

(1) For outstanding payments after the card holder and the guarantor declare bankruptcy and their assets are liquidated in accordance with applicable, the enterprise should provide court certificates of bankruptcy and assets liquidation.
(2) For outstanding payments after the card holder and the guarantor are deceased or are declared missing or dead in accordance with applicable law and the assets or estate is liquidated, the enterprise should provide certificates proving the card holder and guarantor are missing or deceased, and the certificates of assets or estate liquidation.
(3) For uncovered payments after the litigation or arbitration and enforcement procedures, the enterprise should provide the court judgment or arbitration award and certificates of enforcement.

[177] Article 34 (14) of Guo Shui Fa [2009] No. 88.
[178] Article 34 (15) of Guo Shui Fa [2009] No. 88.
[179] Reply on the Scope of Entrusted Loans, Yin Tiao Fa [1997] No. 41, issued by the People's Bank of China on July 4, 1997.
[180] Article 39 of Guo Shui Fa [2009] No. 88.
[181] Article 35 of Guo Shui Fa [2009] No. 88.

(4) In case the card holder and the guarantor close their business due to insolvency and their business licenses are de-registered or revoked by administrative departments of industry and commerce at the county level or above, for the outstanding payments after assets liquidation, the enterprise should provide the government approval documents for close of business and the certificates of de-registration or revocation of business license issued by administrative departments of industry and commerce.
(5) For an unpaid balance of RMB20,000 or less that cannot be recovered after seeking recovery for more than two years, the enterprise should provide the detailed records of loan recovery activities (including original records of telephone, mail, or personal visits with confirmation and signatures of the person handling the case and the person in charge).

Loss on student loans. If a student loan meets the conditions for bad debt of a financial enterprise, the enterprise can recognize the losses based on the following evidence:[182]

Where the debtor is deceased or declared missing or deceased in accordance with applicable law, or completely loses civil conduct capacity or labor capacity, and has no successor or legatee, and the enterprise cannot recover the loan after the loan collaterals and personal assets of the debtor are disposed in accordance with applicable law and the enterprise seeks recourse against the guarantor, the enterprise should provide the declarations that the debtor is deceased or missing, issued by the public security authorities or the death certificate of the debtor issued by public security authorities or a hospital, the certificate of complete loss of civil conduct capacity of the debtor issued by judicial departments, or the certificate of loss of labor capacity of the debtor issued by hospitals above the county level, and information on disposal of collaterals for the student loans and recourse against the guarantor.

(1) For loans that still cannot be repaid after the procedures of court judgment enforcement are taken, the collaterals for the student loan and personal assets of the debtor are disposed of in accordance with applicable law, and the recourse against the guarantor is sought, the enterprise should provide court judgment or final court order for being unable to enforce a judgment, and information on disposal of loan collaterals and seeking recourse against the guarantor.
(2) For loans that still cannot be repaid after the loans are overdue and after the loan collaterals and personal assets of the debtor are disposed in accordance with applicable law, and the recourse against the guarantor is sought within the valid recourse, the enterprise should provide the information of disposal of collaterals and recourse against the guarantor.

[182] Article 36 of Guo Shui Fa [2009] No. 88.

5.17.6 RECOGNITION OF EQUITY INVESTMENT LOSSES

An enterprise may deduct equity investment losses for CIT purposes if any of the following conditions are met:[183]

(1) The investee is declared bankruptcy, closure, or dissolution, or the business license of the investee is canceled, de-registered, or revoked.
(2) The investee has serious financial difficulties and a huge amount of accumulated losses, has not been in business operations for three consecutive years, and there is no plan of reorganization or resuming business.
(3) The enterprise has no control over the investee, the investment period is complete or over 10 years, and the investee incurs operating losses for three consecutive years, resulting in insolvency.
(4) The investee has serious financial difficulties and a huge amount of accumulated losses, and its complete liquidation or the period of its liquidation has lasted more than three years.
(5) Other conditions stipulated by the MOF and the SAT.

The amount of loss of equity investment deducted based on the above criteria should be the investment costs less the recovery from the responsible person and insurance company and the proceeds on disposal or recoverable amount. The recoverable mount is temporarily deemed to be 5 percent of book balance.[184] Once the loss is confirmed, the full amount of loss can be deducted in computing taxable income in the year in which the equity investment loss is incurred.[185]

To claim equity investment losses in compliance with the conditions listed above, the enterprise should provide the following evidence:[186]

(1) A written statement certifying relevant investment losses signed by the legal representative, the principal officer, and the person in charge of finance of the enterprise;
(2) The public notice of bankruptcy and the liquidation documents of the investee, cancellation, and revocation documents issued by administrative office of industry and commerce, administrative orders of relevant government agencies, and the legal documents or other proof of termination of business and cessation of transaction;

[183] Article 6 of Cai Shui [2009] No. 57.

[184] Article 38 of Guo Shui Fa [2009] No. 88.

[185] Article 1 of Public Notice on the Corporate Income Tax Treatment of Equity Loss, SAT Gong Gao 2010 No. 6, issued by the SAT on July 28, 2010.

[186] Article 37 of Guo Shui Fa [2009] No. 88.

(3) The description of cost and recovered value of the equity investment; and
(4) The description and proof of the distribution of liquidating assets of the investee.

5.17.7 LOSS OF MANAGED INVESTMENT

If an enterprise engages a financial management institution to make investments, the enterprise should distinguish debt investment from equity investment and separately consider whether loss of each type of investment satisfies the requirements for deduction for CIT purposes based on the deduction rules for debt investment and equity investment respectively.[187]

5.17.8 LOSS ON GUARANTEE

If an enterprise guarantees the debt of another enterprise and the enterprise pays the debt as a result of default of the debtor, the enterprise can recognize a loss for CIT purposes if the enterprise cannot recover the payment from the debtor. The rules on deduction of receivables should apply (see Chapter 5.17.3). Furthermore, to be eligible for deduction for a guarantee loss, the guarantee must be relevant to the main activities of productions and business operations, such as investment, finance, materials supplies, and product sales, of the guarantor enterprise. If the guarantee is unrelated to those activities, the guarantor enterprise is not allowed to deduct the payments of principal and interest on the default loan for CIT purposes.[188]

5.17.9 NON-DEDUCTIBLE LOSSES

The SAT specifically lists the following losses as non-deductible losses for CIT purposes:[189]

(1) A bad debt loss for an overdue loan that the debtor or the guarantor has economic ability to pay regardless of whatever reasons for non-payment;
(2) A loss resulting from evasion of recovery of creditor's rights in violation of applicable law and regulations;
(3) A loss resulting from the evasion of debt recovery due to administrative intervention;

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187 Article 40 of Guo Shui Fa [2009] No. 88.
188 Article 41 of Guo Shui Fa [2009] No. 88.
189 Article 42 of Guo Shui Fa [2009] No. 88.

(4) A loss on the debt for which an enterprise has not sought recovery against the debtor and the guarantor;
(5) A loss on debt arising from non-operation activities;
(6) A loss on a direct loan from an enterprise other than those that can conduct loan business in accordance with the State regulations; and
(7) Other equity or credit assets of an enterprise that should not be written off.

5.18 Expenses of Real Estate Development

The CIT treatments of the costs and expenses of real estate development are provided the SAT circular, the Measures on the Corporate Income Tax Treatment of Real Estate Development Business.[190] The tax circular is applicable to enterprises that are engaged in real estate development in China, including land development, construction, and the sale of residential or commercial buildings, attachments, and relevant facilities.

In computing CIT, a real estate development enterprise must separately account for period cost and product development cost; the product development cost must be further divided into the cost of sold development product and the cost of unsold development product.[191] An enterprise may deduct period cost, the cost of sold development products, Business Tax and surcharges, and Land Appreciation Tax in computing current year taxable income.[192] In computing the current year deductible cost of sold development products, an enterprise should first determine the unit project cost of saleable area, which is the total development cost of a product divided by total saleable area of the product. The enterprise then will need to calculate the deductible cost of sold development product, which is the size of actual sale of saleable area times the unit project cost of saleable area.[193]

5.18.1 Maintenance Costs

A real estate development enterprise may deduct, in the current period, the maintenance costs that are actually incurred by an enterprise in the course of daily maintenance and repair of unsold completed development products and of sold development products, including common areas and common facilities.[194] If an enterprise includes the maintenance fund for common area and facilities in its revenue, the enterprise may deduct the

[190] Guo Shui Fa [2009] No. 31.
[191] Article 11 of Guo Shui Fa [2009] No. 31.
[192] Article 12 of Guo Shui Fa [2009] No. 31.
[193] Article 14 of Guo Shui Fa [2009] No. 31.
[194] Article 15 of Guo Shui Fa [2009] No. 31.

fund in computing its taxable income at the time the fund is transferred to other entity.[195]

5.18.2 COMMON FACILITIES

An enterprise may incur costs in building common facilities in a development area. Such facilities may include a club house, property management office, electricity, heating, and water supply facilities, cultural and sports facilities, and child care and education facilities[196] Parking facilities constructed in conjunction with an underground infrastructure of a project should be treated as common facilities.[197] Such common facility costs should be handled in accordance with the following provisions:

(1) Where those facilities are not-for-profit and owned by all the property owners, or they are donated to local governments or public utilities, they may be treated as public facilities, and the construction costs of those facilities thereof shall be included in the tax basis of development products.[198]
(2) Where those facilities are for-profit, or are owned by the development enterprise, or the ownerships thereof are not clearly identified or are donated to an entity other than local government or public utilities, their costs shall be calculated independently. Except for facilities developed by enterprises for their own use, which shall be treated as constructions of fixed assets, the facilities should be treated as separate development products.[199]

If a real estate development enterprise builds postal and communication facilities, schools, and medical facilities within the development area, the enterprise shall separately account for the costs of those facilities. If those facilities are jointly developed by the enterprise and government or a public funded organization, and the government or the organization pays the enterprise for the transfer of facilities upon the completion of construction, the enterprise should offset the payment against construction costs and adjust its current year taxable income by the difference between the amount of payment and the construction costs.[200]

[195] Article 16 of Guo Shui Fa [2009] No. 31.
[196] Article 17 of Guo Shui Fa [2009] No. 31
[197] Article 33 of Guo Shui Fa [2009] No. 31
[198] Articles 17 and 27(5) of Guo Shui Fa [2009] No. 31
[199] Article 17 of Guo Shui Fa [2009] No. 31
[200] Article 18 of Guo Shui Fa [2009] No. 31

5.18.3 FINANCIAL CHARGES AND COMMISSION

Real estate development enterprises often sell development products before individual ownership certificates are issued. If a buyer acquires a unit of property by taking a mortgage loan, a bank may require that the real estate development enterprise provide a guarantee on the mortgage before the individual ownership certificate for the unit is issued to the buyer. If a real estate development enterprise provides this type or any other types of guarantee to the lending institutions for the property sold, it may not deduct any fund set aside for such guarantee in computing its taxable income; however, the enterprise may deduct the amount of actual loss when the borrower defaults on the loan and the enterprise actually pays the loan.[201]

There is a ceiling for tax deduction on commission expense paid to overseas entities for sale of development products, which is 10 percent of the sales proceeds.[202] A real estate development enterprise may allocate interest expenses in accordance with accounting standards. If the interest is financial expenses, the enterprise may deduct such expenses for CIT purpose in current year. If an enterprise group takes a loan from a financial institution for the use of several members of the group, the interest reasonably allocated to an enterprise is deductible for the enterprise.[203]

5.18.4 OTHER EXPENSES

Loss incurred by a development enterprise by virtue of reclaim of land use rights by the State without compensation may be deducted as property loss for CIT purposes.[204] Where a development product (cost objective as its measurement unit) is scrapped or damaged, the net loss thereof is allowed to be deducted.[205] If a real estate development enterprise uses a development product for not more than 12 months and then sells the product, the enterprise cannot take a depreciation expenses for the use of such property for the CIT purposes.[206]

5.18.5 CALCULATION OF TAX BASIS

The tax basis of an enterprise in a real estate product developed consists of the costs and expenses allocated into the product in accordance with tax rules. In determining the tax

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[201] Article 19 of Guo Shui Fa [2009] No. 31.
[202] Article 20 of Guo Shui Fa [2009] No. 31.
[203] Article 21 of Guo Shui Fa [2009] No. 31.
[204] Article 22 of Guo Shui Fa [2009] No. 31.
[205] Article 23 of Guo Shui Fa [2009] No. 31.
[206] Article 24 of Guo Shui Fa [2009] No. 31.

basis, the enterprise must identify cost objects and then allocate various costs into the cost objects.

Determination of cost objects. A real estate development enterprise may use the following methods to determine cost objects:

(1) The principle of "salability." If a development product is salable, it should be a cost object where the costs associated with it should be separately accounted for; if an item is unsalable, the enterprise can record the cost of the item in an interim cost account and then allocate the cost into the cost objects of salable products.
(2) The principle of "categorized allocation." Projects which are developed on the same site as a group, completed at similar time and with no apparent difference in the type of structure may be treated as one cost object.
(3) The principle of "differentiated based on function." If a development project consists of relatively independent components with different functions, each component can be treated as a separate cost object.
(4) The principle of "differentiated based on pricing." Development product that are expected to be sold at prices with great variations as a result of differences in the project's type or function shall be treated as separate cost objects.
(5) The principle of "differentiated based on cost." Development products that are constructed at different costs as a result of construction difference should be treated as separate cost objects.
(6) The principle of ownership. Development projects that are built on behalf of parties other than the owner and those that are owned by several parties shall be categorized as different cost objects in accordance with the above-mentioned principles.

A real estate development enterprise should reasonably determine cost objects of a development project prior to the commencement of construction work and should file the determination with the tax authority in charge. Once the methods are selected, the enterprise cannot change them without the consent of the tax authority.[207]

Includable costs in tax basis of development products. The tax basis of a development product should include the following costs:[208]

(1) Land acquisition fee and relocation compensation. This category of cost mainly includes the price of land use rights, the fees for supporting municipal infrastructure and facilities, deed tax, farmland occupation tax, land use fee, land idle fee, additional charges, taxes and fees for the change of land usage and/or

207 Article 26 of Guo Shui Fa [2009] No. 31.

208 Article 27 of Guo Shui Fa [2009] No. 31.

the increase of size, the compensation for the relocation of original property user, the expenses of housing construction for the use of original property user, compensation for crop damage, compensation for dangerous housing, etc.

(2) Pre-construction costs, which include the costs for hydro-geological survey, mapping, planning, design, feasibility study, preparation fee, site leveling, etc. incurred during the pre-construction period.

(3) Construction and installation costs, which mainly include fees for project construction and installation.

(4) Infrastructure construction costs, which include the costs of construction of roads, water supply, electricity supply, gas, sewage, drainage, communications, lighting and other community-based infrastructure as well as the costs of construction of sanitation facilities and garden landscaping.

(5) Supporting public facilities costs. The supporting public facilities are those that are independent from the project, are not-for-profit, and are owned by all property owners or are given for free to the local government or public funded institutions.

(6) Indirect development costs are the costs incurred for direct management of the project and cannot be categorized under any specific cost object. These costs mainly include the salaries of management personnel, staff welfare costs, depreciation, repair expenses, office expenses, water and electricity expenses, labor protection fee, project management fee, the amortization of temporary housing for residents relocated from project site, and the construction costs of marketing facilities for the project.

Computation and allocation of tax basis. A real estate development enterprise should properly assign or allocate development costs into development cost objects. The direct costs and the indirect costs that can be identified for a specific cost object should be assigned to the cost object. Common costs and the indirect costs that cannot be identified for a specific cost object should be allocated based on beneficial and matching principles. The following method of cost allocation can be used:[209]

(1) Land area method. The costs are allocated based on the proportion of the land area used for the development cost object in the total area of the land used for the project. If the land is developed at one single phase, the costs allocated to a cost project are the proportion of the land area of the cost object in the total area of the land used to develop all the cost objects. If the land is developed at several phases, the costs should first be allocated each phase according to the land area of all the cost objects developed at the current phase in the total area of the land used to develop all the cost objects in all phases; and then be allocated to a specific

[209] Article 29 of Guo Shui Fa [2009] No. 31.

cost object based on proportion of the land area of the cost object in the total area of the land used to develop all the cost objects at the phase.

(2) Construction area method. The costs are allocated based on the proportion of the floor area of the development cost object in the total floor area of the project. If the land is developed in one single phase, the costs allocated to a cost project are the proportion of the floor area of the cost object in the total floor area of all the cost objects. If the land is developed in several phases, the costs should first be allocated each phase according to the floor area of all the cost objects developed at the current phase in the total floor area of all the cost objects in all phases, and then be allocated to a specific cost object based on proportion of the floor area of the cost object in the total floor area of all the cost objects at the phase.

(3) Direct cost method. The common costs are allocated based on the direct development costs of a cost object developed in the current period in the total direct development costs for all cost objects developed in the current period.

(4) Construction budget method. The costs are allocated according to the estimated construction cost of a certain cost object developed in the current period in the total estimated construction cost of all cost objects developed in the current period.

Land cost shall generally be allocated by applying the land area method. If an enterprise uses other methods, it must obtain prior consent of the tax authority. The supporting public facilities costs which are accounted as interim cost objects shall be allocated by applying the construction area method. The loan-related expenses to be shared by several cost objects shall be allocated by applying the direct cost method or the construction budget method. The method for allocation of other cost items shall be determined at the enterprise's sole discretion.[210]

Time of cost recognition. If an enterprise contributes land use rights to a real estate development project in exchange for the products developed using the contributed land use rights, the enterprise receiving the land use rights may not recognize the costs of land use rights at the time of contribution; at the first time of distribution of products to the contributing enterprise, the land costs shall be determined based on the fair market value of the products to be distributed (including current and future distributions) to the contributing enterprise and the relevant taxes and fees incurred during transfer of the land use rights. If an enterprise contributes land use rights to a real estate development project in exchange for the products developed not using the contributed land use rights, the receiving enterprise should recognize the costs of land use rights, at the time of contribution, based on the market fair value of the products be distributed to the contributing

[210] Article 30 of Guo Shui Fa [2009] No. 31.

enterprise and the relevant taxes and fees incurred during transfer of the land use rights. If an enterprise contributes land use rights to a real estate development company in exchange for the equity interest in the real estate development company, the receiving enterprise should recognize the costs of land use rights, at the time of contribution, based on the fair market value of the land use rights and the relevant taxes and fees incurred during transfer of the land use rights. In all of the three situations above, if the receiving enterprise pays or receives cash, in addition to the exchange, the receiving enterprise should add the cash payment to or subtract the cash receipts from the cost of land use right.[211]

Tax basis should be the actual costs incurred. However in the following situations, a real estate development enterprise may accrue certain expenses in computing tax basis of a project:[212]

(1) If a real estate development enterprise engages a general contractor for a project, the final settlement for the contract has not been made, and the amount stated in the invoice issued by the contractor is less than the total contract price, then the real estate development enterprise may accrue the difference for CIT purposes provided that sufficient evidence should be provided and the maximum amount of so accrued expense should not exceed 10 percent of the total contract price.
(2) If a real estate enterprise is obligated to build certain supporting public facilities under development products sales contracts, the irrevocable promise in advertisement or project model, or applicable law and regulations, the enterprise may accrue the construction costs of such supporting public facilities that are not yet built or completed based on the reasonable budget of such construction costs.
(3) A real estate development enterprise may obtain various approval certificates for construction of a project. The government will charge various fees during the approval process including mandatory contribution to some public funds. The enterprise may accrue these fees to be paid to the government. If a developer is also required to contribute to property management fund, common facility maintenance, and repair funds, and some other special purpose funds, the enterprise may also accrue the portion borne by the enterprise.

5.19 Net Operating Losses

Losses incurred by an enterprise in a tax year are allowed to be carried forward and utilized against income of subsequent years. The net operating loss carry-forward period

[211] Article 31 of Guo Shui Fa [2009] No. 31.
[212] Article 32 of Guo Shui Fa [2009] No. 31.

is five years.[213] Where the tax authority adjusts the taxable income of a taxpayer for a prior year in a tax audit, the increase of taxable income as a result of such adjustment can be offset by the net operting loss carryovers available for the year of adjustment.[214] Net operating loss is not permitted to be carried back. A resident enterprise generally can file CIT on a consolidated basis for all branches or other form of business establishments within the enterprise. Loss of a business establishment can be used to offset income of other business establishments of the enterprise. However, losses incurred by the overseas business establishment of a resident enterprise cannot be offset against the profits from its business establishments in the PRC.[215] The same principle applies to the asset losses. The asset losses of domestic and overseas business establishments should be accounted for separately. The net operating losses resulting from asset losses of overseas business establishments cannot be deducted in computing the taxable income of domestic operations.[216]

5.20 Taxes

Taxes and surcharges incurred by an enterprise other than the CIT and creditable Value Added Tax are deductible by the enterprise.[217] The deductible taxes and surcharges include Business Tax, City Maintenance and Construction Tax, Education Surcharge, Customs Duty, Stamp Duty, Deed Tax, Land Appreciation Tax, Property Tax, and other similar types of central and local taxes and surcharges. VAT is imposed on the import of goods into China and the transfer of goods and provision of repair and processing services within China. There are two types of VAT payers, general VAT payer and small scale VAT payer. A general VAT payer can credit VAT incurred on purchase of materials, inventories, and equipment against output tax paid on the sales of its products. As such, the VAT incurred by a general VAT payer is not an income statement item and is not a deductible expense for CIT. One exception is where an enterprise incurs an inventory loss as a result of the stock-taking loss, inventory destruction, inventory scrapping, and inventory stolen. In such case, the enterprise is not permitted to credit VAT incurred in acquisition of that inventory and the enterprise can deduct the VAT incurred as part of the asset loss.[218] Because a small-scale VAT payer cannot credit VAT incurred, it should be allowed to deduct the tax.

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[213] Article 18 of the CIT Law.

[214] Public Notice on the Issue of Tax Loss Carryovers Offsetting Increase of Taxable Income as Aduit Adjustment, SAT Gong Gao [2010] No. 20, issued by the SAT on October 27, 2010 and effective on December 1, 2010.

[215] Article 17 of the CIT Implementation Rules.

[216] Article 12 of Cai Shui [2009] No. 57.

[217] Article 31 of the CIT Implementation Rules.

[218] Article 10 of Cai Shui [2009] No. 57.

6

DEPRECIATION AND AMORTIZATION

6.1 Fixed Assets

In calculating its taxable income, an enterprise may deduct depreciation charges on its fixed assets where the charges are calculated in accordance with tax law and regulations.[1] The fixed assets are the non-monetary assets that are used for a period in excess of 12 months and that are held by an enterprise for the production of goods, the provision of services, leasing, or operation and management, including buildings, structures, machinery, mechanical apparatus, means of transportation and other equipment, instruments, and tools that are related to production and business operations.[2]

[1] Article 11 of the CIT Law.

[2] Article 57 of the CIT Implementation Rules.

6.1.1 TAX BASIS

The tax bases of fixed assets are the historical costs of those assets.[3] The tax basis of fixed assets should be determined according to the following methods:[4]

(1) The tax basis of purchased fixed assets shall be determined based upon the purchase price, related taxes and charges paid, and other expenditures that are directly attributed to preparing the assets for their intended use.
(2) The tax basis of self-constructed fixed assets shall be the expenditures that are incurred prior to the completion of such construction.
(3) The tax basis of fixed assets under finance leases shall be the total lease payments under the lease contract and the related expenses that are incurred by the lessee in the course of entering into the lease contract. Where the total lease payments are not specified in the lease contract, the tax basis of fixed assets under finance leases shall be the fair value of the assets and related expenses that are incurred by the lessee in the course of entering into the lease contract.
(4) The tax basis of surplus fixed assets shall be the total replacement value of fixed assets of the same category.
(5) The tax basis of fixed assets that are acquired through donations, investment, exchange of non-monetary assets, debt restructuring, and so forth shall be the fair value of such assets and related taxes and charges paid.
(6) The tax basis of the fixed assets that have been altered shall be the alteration costs that are incurred during the alteration. However, the expenses incurred for the alteration of fully depreciated fixed assets and of fixed assets leased from another party should not be included in tax basis of fixed assets. Rather those expenses are treated as long-term deferred expenses and amortized.[5]

Where a fixed asset has been placed into service but an enterprise has not obtained the full amount of tax invoice because the full payment for the project has not been settled, the enterprise may record the cost of and depreciate the fixed asset based on the contract price. When the final invoice is issued, the enterprise should make necessary adjustment based on the invoice. Such adjustment should be made within 12 months after the asset is placed into service.[6]

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[3] Article 56 of the CIT Implementation Rules.

[4] Article 58 of the CIT Implementation Rules.

[5] Article 13 of the CIT Law.

[6] Article 5 of Guo Shui Han [2010] No. 79.

6.1.2 NORMAL DEPRECIATION METHOD AND RECOVERY PERIODS

The normal allowable method of depreciation for CIT purposes is the straight-line method. An enterprise should commence the calculation of depreciation expenses for the fixed assets in the month following the month in which the assets are placed in services. Where a fixed asset ceases to be used, the enterprise shall stop the calculation of depreciation expenses in the month following the month during which the fixed asset ceases to be used. An enterprise shall reasonably determine the estimated residual value of fixed assets taking into account the nature and the use of the fixed assets. Once the residual value is determined, it shall not be changed.[7] Old tax law and regulations set forth minimum residual value that is excludable from a depreciable base of fixed assets in computing depreciation expenses. For foreign invested enterprises and foreign enterprises, the residual value cannot be less than 10 percent of the cost basis of fixed assets unless otherwise approved by the tax authority in charge.[8] Domestic enterprises, on the other hand, were allowed to set up residual value not more than 5 percent of fixed assets.[9] From June 18, 2003 to December 31, 2007, domestic enterprises were required to set up the residual value at 5 percent of fixed assets.[10] On and after January 1, 2008, the CIT Law and the CIT Implementation Rules allow enterprises to set up their own residual value. If a fixed asset was placed in services prior to the implementation of the CIT Law and an enterprise continues to use the asset after the implementation of the CIT Law, the enterprise may reassess the residual value according to the CIT Law. If the reassessment is made, the enterprise should determine the recovery period of the asset according to the CIT Law, subtract the period of depreciation that has been accrued under the old tax law from the newly determined recovery period, and calculate depreciation expenses of the remaining tax basis based on the depreciation method prescribed in the CIT Law. If the recovery periods of fixed assets adopted prior to the implementation of the CIT Law are not in violation of the provisions of the CIT Law, an enterprise can continue to use the method to depreciate those assets.[11]

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[7] Article 59 of the CIT Implementation Rules.

[8] Article 33 of the FEIT Regulations.

[9] Article 31 of the Detailed Rules for Implementation of Provisional Regulations of the PRC on Enterprise Income Tax, issued by the MOF on February 4, 1994 and effective from January 1, 1994 to December 31, 2007.

[10] Article 2 of the Notice on Follow-up Administration for the Canceled Examination and Approval Items of Enterprise Income Tax, Guo Shui Fa [2003] No. 70, issued by the SAT on June 18, 2003; the Notice on Clarification of Implementation Period for Adjusting Residual Value Percentage of Fixed Assets for Enterprises, Guo Shui Han [2005] No. 883, issued by the SAT on September 14, 2005.

[11] Article 1 of the Notice on Several Issues Concerning the Transition of Corporate Income Tax, Guo Shui Han [2009] No. 98, issued by the SAT on February 27, 2009.

Under the CIT Law and the CIT Implementation Rules, unless otherwise prescribed by the departments of the State Council in charge of finance and taxation, the minimum periods for calculating depreciation expenses for fixed assets are as follows:[12]

(1) Buildings and structures—20 years;
(2) Aircraft, trains, vessels, machinery, mechanical apparatus, and other production equipment—10 years;
(3) Instruments, tools, and furniture, that are connected with production and business operations—5 years;
(4) Means of transportation other than aircraft, trains, and vessels—4 years;
(5) Electronic equipment—3 years.

6.1.3 ACCELERATED DEPRECIATION

An enterprise may accelerate depreciation of its fixed assets where (1) fixed assets are upgraded and replaced frequently due to advancement in technologies or (2) fixed assets are exposed to constantly high levels of vibration or corrosion. In those situations, an enterprise may shorten depreciable periods or adopt an accelerated depreciation method.[13] To avail of the accelerated depreciation, an enterprise should demonstrate that the estimated life of a fixed asset is shorter than the minimum depreciable period prescribed in the CIT Implementation Rules. If an enterprise places a new fixed asset into services and the enterprise had never used an asset whose functions are the same or similar to the new asset, the enterprise may adopt a shorter depreciable period or accelerated depreciation method only if it has sufficient evidence that the estimated useful life is shorter than the depreciable period prescribed in the CIT Implementation Rules. If the enterprise replaces an old fixed asset before the completion of its depreciation period with a new fixed asset having the same or similar function of the old asset, the enterprise may adopt a shorter depreciable period or accelerated depreciation method based on the actual life of the old asset and the tax rules.[14] If an enterprise shortens the depreciation periods, such periods shall not be shorter than 60 percent of the depreciation periods prescribed in the CIT Implementation Rules.[15] If an enterprise acquires a used fixed asset, the depreciation period should not be shorter than 60 percent of the balance of the minimum depreciation period prescribed in the CIT Implementation Rules less the used

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[12] Article 60 of the CIT Implementation Rules.

[13] Article 32 of the CIT Law; Article 98 of the CIT Implementation Rules.

[14] Article 2 of the Notice on the Issues Concerning Corporate Income Tax Treatment of Accelerated Depreciation of Fixed Assets, Guo Shui Fa [2009] No. 81, issued by the SAT on April 16, 2009 and effective on January 1, 2008.

[15] Article 98 of the CIT Implementation Rules.

life of the asset. Once the minimum depreciation period is determined, such period generally cannot be changed.[16]

For the accelerated depreciation method, either the double-declining-balance method or the sum-of-the-years-digits method can be adopted.[17] Once an accelerated depreciation method is adopted, such method generally cannot be changed.[18]

Under the double-declining balance method, the following formula is used in computing depreciation:

$$\text{Annual depreciation rate} = 2 \div \text{Estimated useful life in years} \times 100\%$$

$$\text{Monthly depreciation rate} = \text{Annual depreciation rate} \div 12$$

$$\text{Monthly depreciation amount} = \text{Net book value at the beginning of month} \times \text{Monthly depreciation rate}$$

Since declining-balance depreciation doesn't always depreciate an asset fully by its end of life, the tax rule requires an effective conversion from the declining-balance depreciation to straight-line depreciation for the last two years of an asset's life. The taxpayer needs to subtract estimated residual value from net asset value at the beginning of the last two years of the asset's life and then depreciate the balance using the straight-line method over the last two years.[19]

Under the sum-of-the-years-digits method, the following formula should be used to compute depreciation expenses of a fixed asset:[20]

$$\text{Annual depreciation rate} = \text{Remaining years of useful life} \div \text{The sum of years digits of estimated useful life} \times 100\%$$

$$\text{Monthly depreciation rate} = \text{Annual depreciation rate} \div 12$$

$$\text{Monthly depreciation amount} = (\text{Original cost} - \text{Estimated residual value}) \times \text{Monthly depreciation rate}$$

For example, for a fixed asset having a useful life of 5 years, the Years' digits are: 5, 4, 3, 2, and 1 and the sum of the digits is 15 (5+4+3+2+1). The depreciable cost, i.e., original

[16] Article 3 of Guo Shui Fa [2009] No. 81.

[17] Article 98 of the CIT Implementation Rules.

[18] Article 4 of Guo Shui Fa [2009] No. 81.

[19] Id.

[20] Id.

cost less Estimated residual value, will be depreciated at 5/15 for the first year, 4/15 for the second year, 3/15 for the third year, 2/15 for the fourth year, and 1/15 for the fifth year.

If an enterprise needs to shorten depreciable period or adopt an accelerated depreciation method, the enterprise must file with the tax authority in charge within one month after acquiring the asset. The enterprise should submit the following documents to the tax bureau:

(1) The function of the fixed asset and the reasons that its estimated useful life is shorter than the minimum depreciation period described by the CIT Implementation Rules and the supporting documents;
(2) The function of the replaced fixed asset and the explanations of use and disposal of the replaced asset;
(3) The explanation of accelerated depreciation method that the enterprise plans to adopt; and
(4) Other materials as required by the tax authorities.

The tax bureau in charge will inspect the actual surroundings where the fixed asset is used at the time of annual tax assessment. If the fixed asset does not meet the requirements for accelerated depreciation, the tax authority has the right to request that the enterprise stop accelerated depreciation.[21] If an enterprise adopts a useful life shorter than the minimum life prescribed by the CIT Implementation Rules and if the enterprise continues to use the asset for more than 12 months after the end of the adopted shorter useful life, the enterprise cannot use a shorter useful life for the subsequently replaced asset or rebuilt assets with similar functions.[22]

6.2 Biological Assets

Biological assets used for production refers to biological assets that are held by an enterprise for the production of agricultural products, the provision of services, leasing, and so forth, including economic forests, forests of charcoal and firewood, productive livestock, and draft animals,. The tax basis of biological assets used for production shall be determined using the following methods:[23]

(1) For purchased biological assets used for production, the tax basis is the purchase price and related taxes and charges paid;

[21] Article 5 of Guo Shui Fa [2009] No. 81.
[22] Article 6 of Guo Shui Fa [2009] No. 81.
[23] Article 62 of the CIT Implementation Rules.

(2) For biological assets used for production that are acquired through donation, investment, exchange of non-monetary assets, and debt restructuring, the tax basis shall be the fair value of such assets and related taxes and charges paid.

6.3 Oil and Gas Enterprises

Enterprises engaged in oil and nature gas, including coal bed methane, exploration are subject to a special rule for depreciation, depletion, and amortization of certain expenses for fixed. This special rule is applicable to the expenses incurred by the oil and gas enterprises prior to commercial production period. The commercial production period is the period where oil or gas wells can steadily produce oil and gas for commercial sales after exploration and development.[24]

6.3.1 Expenses of Acquisition of Exploration Rights

An oil and gas enterprise may incur various expenses in acquiring exploration rights, exploitation rights, land use rights, or sea use rights for the mining areas, including various fees for granting those rights, professional fees and other reasonable expenses directly attributable to the acquisition of those rights and interests in mining areas. The enterprise may choose to deduct those expenses in the current period against income derived from the enterprise's other oil (gas) fields. Alternatively, the enterprise may amortize those expenses using the straight-line method over a period of three years from the month following commencement of commercial production in the corresponding oil (gas) field. Where an oil and gas enterprise elects not to deduct those expenses currently and terminates operations due to its failure to find a commercially viable oil (gas) structure, the enterprise can write off the unamortized balance of those expenses as a loss in the year in which operations are terminated.[25] Once an oil and gas enterprise elects to deduct or amortize the costs of exploration rights, it cannot subsequently change the method elected.[26]

6.3.2 Exploration Expenses

Exploration expenses refer to all expenses incurred by oil and gas enterprises in geological surveys, geophysical exploration, shaft exploration activities, and other relevant activities

[24] Article 1 of the Notice of Tax Treatment of Depreciation and Deletion for Expenses and Relevant Fixed Assets for Oil and Gas Production Enterprises, Cai Shui [2009] No. 49, issued by the MOF on April 12, 2009 and effective on April 12, 2009.

[25] Article 2 of Cai Shui [2009] No. 49.

[26] Article 5 of Cai Shui [2009] No. 49.

to identify exploration areas and verify oil and gas reserves. Except for those incurred in respect of shaft exploration that are anticipated to become assets, all expenses incurred by oil and gas enterprises prior to commencing commercial production may be deducted from income derived from the enterprise's other oil (gas) fields in the same period in which such expenses are incurred. Alternatively, such expenses can be amortized using the straight-line method over a period of three years from the month following commencement of commercial production in the corresponding oil (gas) field.[27] Once an oil and gas enterprise elects to deduct or amortize the exploration expenses, it cannot subsequently change the method elected.[28] Where an oil and gas enterprise elects not to deduct exploration expense currently and terminates operations due to its failure to find a commercially viable oil (gas) structure, the expenses that have not yet been deducted shall be deducted as losses in the year in which operations are terminated. If a shaft is determined to be commercially viable and the assets formed as a result of the oil and gas enterprise's expenditure on exploration activities has a useful life of more than 12 months, such shaft exploration expenses shall be carried forward as the cost of developing such assets and depreciated in accordance with the rules of depreciation of development assets.[29]

6.3.3 DEPRECIATION OF DEVELOPMENT ASSETS

Development expenses are all expenses incurred in constructing or renovating shafts and facilities relevant to the acquisition of oil and gas in proven mining areas. All development expenses incurred by an oil and gas enterprise prior to commercial production shall, regardless of the purpose of such expenditure, be aggregated as the cost of developing such assets. The enterprise can depreciate the development assets, using the straight-line method without residual value, from the month following commencement of commercial production for the corresponding oil (gas) field. The minimum depreciation period is eight years.[30] Once an oil and gas enterprise determines the years of depreciation of development expenses, it cannot subsequently change the years determined.[31] Where an oil and gas enterprise terminates production in an oil (gas) field, outstanding depreciation charges for development assets shall be deducted as losses in the year in which production in the relevant oil (gas) field is terminated.[32]

[27] Article 3 of Cai Shui [2009] No. 49.
[28] Article 5 of Cai Shui [2009] No. 49.
[29] Article 3 of Cai Shui [2009] No. 49.
[30] Article 4 of Cai Shui [2009] No. 49.
[31] Article 5 of Cai Shui [2009] No. 49.
[32] Article 4 of Cai Shui [2009] No. 49.

6.3.4 ABANDONMENT COSTS

When an oil or gas well becomes unprofitable or has been proven non-productive, it will be abandoned. Substantial costs will be incurred on decommissioning, abandonment and removal off offshore oil and gas installation. In 2000, the MOF and the SAT issued a circular addressing the tax treatment of abandonment costs for Chinese-foreign cooperative offshore oil and gas exploitation.[33] According to the 2000 tax circular, when a Chinese-foreign cooperative offshore oil and gas project production completes, the Chinese and foreign oil companies in the cooperative project should determine the net abandonment cost by subtracting sale proceeds from the actual abandonment expenses. Such net abandonment cost should be confirmed by the tax authority in charge. If the Chinese and foreign companies in the cooperative project have income from another offshore oil and gas project with identical parties, the abandonment cost should be amortized over a period of five to ten years using straight line method in computing the taxable income from the other oil and gas project. If life of income of the the project is less than five years, the amortization period should be the actual income years. If there is no income from a subsequent oil and gas project with the identical parties, the abandonment cost can be carried back for three years in computing taxable income. If tax has been paid for the carry back period, it can be refunded.

In June 2010, National Development and Reform Commission, National Energy Bureau, the MOF, the SAT, and State Oceanic Administration issued the Provisional Measures on Administration of Abandonment of Offshore Oil and Gas Production Facilities.[34] According to the June 2010 circular, the operator of an offshore oil/gas project must prepare an abandonment plan at the time it prepare exploitation plan before the commencement of commercial exploitation. The operator may amend the abandonment plan after three years after the commencement of commercial production. For an offshore oil/gas project that commenced commercial production before June 23, 2010, the operator should prepare the abandonment plan before June 23, 2012. The abandonment plan should be filed with the State agencies in charge of energy, finance, and taxation.[35] An operator of offshore oil/gas filed should accrue the abandonment expenses each month on either straight-line or unit of production basis. Once the method is adopted, it cannot be changed. If the commercial production commences on or after June 23, 2010, the operator should start the monthly abandonment expense accrual from the month

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[33] Notice on Tax Treatment of Abandonment Costs of Offshore Oil and Gas Wells by Chinese-Foreign Cooperative Projects, Cai Shui Zi [2000] No. 21, issued by the MOF and the SAT on Feburary 18, 2000.

[34] The Notice on Issuing the Provisional Measures on Administration of Abandonment of Offshore Oil and Gas Production Facilities, Fa Gai Neng Yuan [2010] No. 1305, issued by National Development and Reform Commission, National Energy Bureau, the MOF, the SAT, and State Oceanic Administration on June 23, 2010.

[35] Article 7 of Fa Gai Neng Yuan [2010] No. 1305.

following the month of commencement of commercial production. If the project commenced its commercial production before June 23, 2010, the operator should start accruing the abandonment expenses from the month following the month in which the abandonment plan is initially filed.[36] Where the accrued abandonment expenses are not sufficient to settle all the abandonment liabilities after the completion of commercial production, the shortage should be provided one-time. On the other hand, if the accrued expenses are greater than the actual abandonment expenses, the excess amount should be returned.[37] For a Chinese-foreign cooperative offshore oil/gas exploitation project, the accrued abandonment expenses should be deposited at a special bank account within the PRC. Such bank should be jointly designated by the Chinese and foreign investors of the project. Interest earned on the bank deposit should be also part of the fund for abandonment costs.[38] The June 2010 circular does not expressly provide the tax treatment of the abandonment costs. Presumably, the abandonment expenses should be deductible at the time of accrual for CIT purposes. The SAT is expected to issue a tax circular providing rules for the implementation of the June 2010 circular. This circular has not been issued at the time of completion of manuscript of this book.

6.4 Intangibles

In calculating its taxable income, an enterprise can deduct the amortization charges on intangible assets.[39] Intangible assets are incorporeal, non-monetary, long-term assets that are held by an enterprise for the production of goods, provision of services, leasing or operation and management, including patents, trademarks, copyrights, land use rights, proprietary technologies, goodwill, and so forth.[40] The tax basis of intangible assets should be determined using the following methods:[41]

(1) The tax basis of purchased intangible assets shall be the purchase price, related taxes and charges paid, and other expenditures that are directly attributed to preparing the assets for their intended use;
(2) The tax basis of self-developed intangible assets shall be the expenses that are incurred by an enterprise during the period from when the intangible assets first meet the criteria for capitalization to when the intangible assets reach the stage of their intended use.

[36] Article 14 of Fa Gai Neng Yuan [2010] No. 1305.
[37] Article 15 of Fa Gai Neng Yuan [2010] No. 1305.
[38] Article 18 of Fa Gai Neng Yuan [2010] No. 1305.
[39] Article 12 of the CIT Law.
[40] Article 65 of the CIT Implementation Rules.
[41] Article 66 of the CIT Implementation Rules.

(3) The tax basis of intangible assets that are acquired through donations, investments, exchanges of non-monetary assets, debt restructurings, and so forth shall be the fair value of the assets and the related taxes and charges paid.

Intangible assets must be amortized using the straight-line method. Intangible assets that are acquired through investments or acquisition should be amortized over their lives prescribed under relevant laws or contracts. Other intangible assets should be amortized over ten years. However, expenditures that are incurred in acquiring goodwill are not amortizable. Such expenses must be capitalized in the tax basis of the acquired business; the enterprise can deduct the capitalized expenses when it disposes of the entire business or liquidates the enterprise.[42] The CIT Law and the CIT Implementation Rules do not provide detailed rules on the allocation of the purchase price. Presumably, the purchaser and seller may agree on the price allocation based on the fair market value of the assets, rather than book value of the assets. It is not clear whether the purchaser or both parties may allocate a portion of the purchase premium over the net book value of the assets to some identifiable intangibles that were not on the seller's books. Those intangibles may include the in-process R&D, customer list, and non-competition agreements. As those identified intangibles are not goodwill, arguably those intangibles should be deductible or amortizable over the useful life period of the assets.

6.5 Long-Term Deferred Expenses

Long-term deferred expenses are certain expenses paid by an enterprise whose amortization period is more than one year. The CIT Law allows a deduction of those expenses based on a matching principle. The CIT Law and the CIT Implementation Rules list the following long-term deferred expenses:

(1) Expenses incurred for the alteration of fully depreciated buildings and structures, and extension of their useful lives or similar expenses. Such deferred expenses should be amortized over the estimated remaining useful life of the fixed assets.[43]
(2) Expenses incurred for the alteration of leased buildings and structures. Such leasehold improvement should be amortized over the remaining lease term stipulated in the lease contract.[44]
(3) Expenses incurred for the overhaul of fixed assets. Such expenses must be more than 50 percent of the tax basis at the time of the acquisition of the fixed assets

[42] Article 67 of the CIT Implementation Rules.
[43] Article 13(1) of the CIT Law; Article 68 of the CIT Implementation Rules.
[44] Article 13(2) of the CIT Law; Article 68 of the CIT Implementation Rules.

and the overhaul must extent the useful life of the assets for more than two years. The expenses that meet the above criteria should be amortized over the remaining useful life of the fixed assets.[45]

(4) Other expenses that should be treated as long-term deferred expenses. Those expenses should be amortized over a period of not less than three years starting from the month following the month during which the expenditures are incurred.[46]

6.6 Pre-operating Expenses

Prior to January 1, 2008, pre-operating expenses were treated as intangible assets and generally should be amortized over no less than 5 years, using the straight-line method, starting from the month of production or business operations.[47] On and after January 1, 2008, an enterprise can deduct the full pre-operating expenses in the year when the enterprise commences its business operations. Alternatively, the enterprise can elect to treat pre-operating expenses as long-term deferred expenses and amortize them over three years. Once the election is made, the enterprise cannot change the treatment. For the balance of pre-operating expenses incurred prior to January 1, 2008, an enterprise can continue to amortize them based on the provisions of old tax law and regulations after January 1, 2008. The enterprise may also apply the rules under new CIT Law to such balance.[48] As an enterprise cannot deduct any expenses during a pre-operating period, it should compute its first profit or loss year in the year it commences its production or business operations.[49]

[45] Article 13(3) of the CIT Law; Article 69 of the CIT Implementation Rules.

[46] Article 13(4) of the CIT Law; Article 70 of the CIT Implementation Rules.

[47] Article 49 of the Implementation Rules for FEIT Law; Article 34 of the Detailed Rules for the Implementation of the Provision Regulations of the PRC on Enterprise Income Tax.

[48] Article 9 of Guo Shui Han [2009] No. 98.

[49] Article 7 of Guo Shui Han [2010] No. 79.

7

MERGERS AND ACQUISITIONS

7.1 General

Prior to January 1, 2008, different merger and acquisition tax rules applied to domestic enterprises and foreign invested enterprises and foreign enterprises, respectively. On January 1, 2008, the CIT Law came into effect, unifying the two systems. However, the new tax law does not specifically address the tax treatment of merger and acquisition transactions. Article 75 of the CIT Implementation Rules provides that unless otherwise prescribed by the State Council departments in charge of finance and taxation, an enterprise shall recognize, at the time the transactions take place, gains or losses that arise out of transfers of assets in the course of reorganization. The CIT Law and the CIT Implementation Rules basically authorize the MOF and the SAT to issue merger and acquisition tax rules in the form of tax circulars. On April 30, 2009, the MOF and the SAT issued the Notice on Certain Issues of Corporate Income Tax Treatment of Enterprise Reorganizations.[1] The notice prescribes CIT treatment for various types of reorganizations, including debt restructurings, acquisitions of equity, acquisitions of assets, mergers, and de-mergers. Compared with the merger and acquisition rules issued under the old tax law and regulations, the new rules provide more detailed guidance in some areas. However,

[1] The Notice on Certain Issues of Corporate Income Tax Treatment of Enterprise Reorganizations Cai Shui [2009] No. 59, issued by the MOF and the SAT on April 30, 2009 and effective on January 1, 2008.

the new rules are still unclear in many aspects The limited available forms for tax-free reorganizations and strict requirements of application of those forms make itdifficult for many transactions, specically cross-borader transactions, to qualfy for tax-free reorganizations. The SAT subsequently issued a circular[2] in July 2010 that primarily addresses filings and documentation matters in implementing the enterprise reorganization notice. Furthermore, some of the rules of enterprise reorganization do not seem neutral; they discourage business transactions in some situations. Hopefully, the MOF and/or SAT will further review the rules and clarify some of the issues by issuing additional circulars. This chapter will analyze the new enterprise reorganization rules.

7.2 Classification of Reorganizations

Enterprise reorganizations are classified into ordinary reorganization and special reorganization based on the different tax treatment.[3] An ordinary reorganization is a taxable transaction in which the CIT Implementation Rules governing normal asset transfers should apply. A special reorganization is a tax-free reorganization in which recognition of gain or loss will be fully or partially deferred. An enterprise organization will be treated as an ordinary reorganization unless the transaction meets specific requirements for one or more types of special reorganizations and the parties elect to avail the transaction of the special reorganization rules.

Enterprise reorganizations can also be classified into the following types of reorganizations based on the nature of transactions:[4]

(1) Change of legal form. This includes the change of registered name of an enterprise, the change of registered address of an enterprise, the change of organizational form of an enterprise, and other simple changes regarding an enterprise. This type of reorganization does not include a reorganization that can be classified as any other types of reorganization.
(2) Debt restructuring. This is an arrangement between a debtor and its creditors relating to debts as a result of financial difficulties of the debtor. In a debt restructuring, the creditors make certain concessions based on a written agreement between the debtor and the creditors or on a court decision.
(3) Stock acquisition. An enterprise acquires shares of another enterprise and the acquiring enterprise controls the other enterprise after the transaction.

[2] The Measures on Administration of Corporate Income Tax Concerning Enterprise Reorganizations, issued by the SAT, via SAT Gong Gao 2010 No. 4, on July 26, 2010 and effective from January 1, 2010.

[3] Article 3 of Cai Shui [2009] No. 59.

[4] Article 1 of Cai Shui [2009] No. 59.

(4) Asset acquisition. An enterprise acquires all or part of the business assets of another enterprise.
(5) Merger. This is a combination of two or more enterprises in accordance with law where one or more enterprises transfer all of their assets and liabilities to another existing or newly established enterprise and the shareholders of merged enterprise receive equity or non-equity considerations.
(6) De-merger. This is a split of one enterprise into two or more enterprises in accordance with law where one enterprise transfers all or part of its assets and liabilities to one or more existing or newly established enterprises and the shareholders of the transferor receive shares of the transferees and/or non-equity consideration.

7.3 Parties to Reorganization and Date of Reorganization

Parties to a reorganization have the right to elect the special reorganization tax treatment if the reorganization satisfies all the requirements of special reorganization. However, all parties to a reorganization must take the same position as to whether to treat the reorganization as an ordinary or special reorganization.[5] All parties to a reorganization are:[6]

(1) the debtor and creditors in a debt restructuring;
(2) the seller, the buyer, and the enterprise acquired in a stock acquisition;
(3) the seller and buyer in an asset acquisition;
(4) the surviving enterprise, merged enterprise, and shareholders of the surviving and merged enterprises in a merger; and
(5) the de-merged enterprise, spin-off enterprise, and the shareholders of the de-merged enterprise and spin-off enterprises in a de-merger.

The date of reorganization is an important reference date for tax treatment or filings with respect to a reorganization. For example, a gain or loss generally is recognized on the date of reorganization in an ordinary reorganization; however, a holding period is required in certain special reorganizations, and commences on the date of reorganization. The date of reorganization also determines the tax year for which an enterprise should report a special reorganization. The date of reorganization is:[7]

(1) for a debt restructuring, the effective date of debt restructuring agreement;
(2) for a stock acquisition, the date that the share transfer agreement is effective and the registration of ownership change has been completed;

[5] Article 4 of SAT Gong Gao 2010 No. 4.
[6] Article 3 of SAT Gong Gao 2010 No. 4.
[7] Article 7 of SAT Gong Gao 2010 No. 4.

(3) for an asset acquisition, the date that the asset purchase agreement is effective and the actual closing has taken place;
(4) for a merger, the date that the surviving enterprise has obtained the ownership of assets of a merged enterprise and the business registration has been completed; and
(5) for a de-merger, the date that the spin-off enterprise has obtained the ownership of assets of de-merged enterprise and the business registration has been completed.

7.4 Ordinary Reorganizations

As a general rule, each party to an ordinary reorganization should recognize gain or loss at the time of the transaction. The tax circular concerning enterprise reorganizations provides the following guidance regarding specific taxable reorganizations.

7.4.1 CHANGE OF LEGAL FORMS OF ENTERPRISE

A conversion of a legal person such as a corporation into a sole proprietorship, partnership, or other non-legal person organization is a taxable event. The company shall be deemed to have been liquidated, with all assets distributed to the owners of the company, and the owners shall be deemed to have set up a new entity by contributing the assets.[8] At the liquidation or deemed liquidation of company, the company is deemed to transfer its assets at fair market value and therefore recognizes gain or loss on the deemed transfer. The owners of the company will recognize gain or loss on the deemed distribution. For detailed discussions of liquidation, please see Chapter 13. As the owners of the company recognize the gain or loss on the deemed distribution, the owners' tax basis in the assets will be equal to the fair market value of the deemed distributed assets. As such, when the owners are deemed to contribute those assets to a newly formed entity, the owners' tax basis in their investment in the new entity will be equal to the fair market value of the assets. The tax basis of the new entity in the assets will also be equal to the fair market value of the assets.[9]

The same tax treatment applies to a change of place of registration of an enterprise from China to a foreign country or region (including Hong Kong, Macao, and Taiwan). The change of registration is treated as a deemed liquidation of a Chinese company and a deemed contribution to the offshore entity by the owners. Under PRC Company Law and other relevant laws and regulations, a company established under Chinese laws cannot

[8] Article 4(1) of Cai Shui [2009] No. 59.
[9] Article 4(1) of Cai Shui [2009] No. 59.

simply change its place of registration from China to overseas. The company must go through formal liquidation procedures. Such a change of legal form would result in an actual legal liquidation. One question is whether it is a taxable event for a China resident enterprise to move its place of registration overseas while maintaining its China resident enterprise status due to the place of effective management within China. In such a situation, even though the enterprise maintains its resident enterprise status, such an event should be taxable because it does not fit into any category of special reorganization.

The taxable event of change of legal form does not include a mere change of registered name, registered address, or form of organization. For such simple changes of legal form, the enterprise needs only to update its tax registration; unless otherwise provided, the tax attributes of the original enterprise generally will be inherited by the changed enterprise. The enterprise after the change can continue to use losses generated prior to the change. The changed enterprise can continue to enjoy the tax incentives granted to the enterprise before the form change unless the enterprise is no longer qualified for the incentives as a result of the change.[10] The change of registered address is the moving of the place of business registration of an enterprise from one location to another within China. Such change often results in the change of tax bureau in charge of the enterprise. For example, a change of business registration from City A to City B will cause the change of collection tax bureau. The enterprise will need to de-register with the tax bureau of City A and register with the tax bureau in City B. If the enterprise maintains its business operations in the form of a branch in City A, the enterprise must convert the tax registration of the enterprise to the tax registration of the branch. No gain or loss will be recognized as a result of tax de-registration and registration. However, at a tax de-registration, the tax bureau often will examine the past tax compliance of the de-registering entity and assess tax liabilities if any underpayment of tax is found. The change of form of organization refers to the change of legal form from one type of legal person to another under Chinese laws. The conversion of a limited liability company into a joint stock company is an example of this type of change. No gain or loss will be recognized by the company or its shareholders as a result of the change except for the shareholders who sell their shares during the conversion.

7.4.2 ENTERPRISE DEBT RESTRUCTURING

A debt restructuring is often involved in a settlement of debt with a consideration less than the amount as provided in the original financing agreement or the settlement is fully or partially made in non-cash consideration. If an enterprise settles its debt with non-cash assets, the debtor enterprise is treated to sell the assets at fair market value and then pay the debt. The debtor enterprise will recognize gain or loss on the deemed asset

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[10] *Id.*

sale and then gain or loss on the debt settlement.[11] For example, an enterprise borrows RMB1,000,000 from a bank. In a debt restructuring, this borrower transfers a building to the bank as a full settlement of the debt. Suppose the borrower's tax basis in the building is RMB500,000 and the market value of building is RMB900,000. The borrower will have a gain of RMB400,000 (RMB900,000 fair market value less RMB500,000 basis) on the deemed sale of building and then a gain of RMB100,000 on debt settlement (RMB1,000,000–RMB900,000). The lender will have a debt restructuring loss of RMB100,000. The lender's tax basis in the building will be RMB900,000.

If a creditor enterprise converts its debt into equity of the debtor enterprise, the conversion is treated first as payment of the debt by the debtor and then as an investment by the creditor. In such a deemed debt repayment, the debtor enterprise should recognize gain or loss on the settlement.[12] Suppose that the debtor issues 100 shares with market value of RMB8 per share to the creditor in exchange of cancellation of a debt of RMB1,000. The debtor will be treated first as obtaining a settlement of debt with a payment of RMB800, and should recognize a gain of RMB200. The creditor will have a loss of RMB200 on the deemed debt payment. The creditor then is treated as making an investment of RMB800 in the debtor enterprise. The tax basis of the creditor in 100 shares of the debtor is RMB800.

A debt restructuring in principle will not change the debtor's tax attributes.[13] It is common that the debtor has substantial loss carryovers because of financial difficulties. The debtor can use its loss carryovers to offset full or part of gain recognized on the debt settlement. The debtor can continue to carry forward the balance of unutilized losses to future years within the allowed net operating loss carryover period. Even if the debt restructuring results in a majority ownership change (i.e., debt to equity conversion), no limitation will be imposed on the use of loss carryover. The eligibility of the debtor for tax incentives generally will not be changed as a result of a debt restructuring.

7.4.3 STOCK ACQUISITION

Where an enterprise acquires stock of another enterprise, the shareholder(s) of the acquired enterprise should recognize gain or loss on the transfer of stock.[14] Such gain or loss should be recognized at the time where the equity transfer agreement becomes effective and the necessary procedures for change of shareholder have been completed. The gain or loss is the difference between the consideration received for the stock transfer and their tax basis in the stock. In computing the gain or loss, the transferor cannot

[11] Article 4(2)(1) of Cai Shui [2009] No. 59.

[12] Article 4(2)(2) of Cai Shui [2009] No. 59.

[13] Article 4(2)(4) of Cai Shui [2009] No. 59.

[14] Article 4(3) of Cai Shui [2009] No. 59.

deduct any undistributed retained earnings of the company.[15] The tax basis in the stock received by the acquiring enterprise should be determined according to the fair market value of the stock.[16] If the acquiring enterprise pays the consideration in cash, the amount of cash in principle should be the basis in the stock investment; if non-monetary consideration is paid for the stock, the fair market value of the assets should be the tax basis in the stock.

When a non-resident enterprise transfers equity interest in a China-resident enterprise, the non-resident enterprise generally should be liable for CIT on the gain derived from the transfer. The gain is the transfer price in excess of the cost of investment in the equity. If the non-resident enterprise directly invests in the Chinese-resident enterprise, the cost of investment is the amount of actual contribution made by the non-resident enterprise. If, however, the non-resident enterprise acquires the equity from other investors, the cost is the consideration actually paid for the equity. At the time of transfer, if the Chinese-resident enterprise has undistributed retained earnings and the various reserves allocated from its tax-after profits, the non-resident transferor cannot deduct such retained earnings and reserves in computing capital gain.[17] This provision is consistent with the general rule of withholding tax on dividends paid to non-resident enterprises. However, the provision does not distinguish pre-2008 earnings from post-2007 earnings. According to the current tax law and regulations, a non-resident shareholder is subject to 10 percent withholding tax on dividends paid by a resident enterprise. However, if the dividends are distributed out of the earnings generated prior to January 1, 2008, such withholding tax is exempted. If this non-deduction rule applies to pre-2008 earnings, such application would be inconsistent with the exception to general rule of withholding tax on dividends concerning pre-2008 earnings and may result in additional tax on the transfer of equity. For example, suppose a non-resident enterprise N contributed 100 as registered capital to its wholly owned Chinese subsidiary S; S has 20 of pre-2008 retained earnings. If N sells shares of S for 180, N would have 80 (180–100) of capital gain. However, if N distributes 20 dividends before the share transfer and then sells the shares for 160, N would have only 60 (160–100) gain and N would not be subject to withholding tax on the 20 dividends.

If a non-resident enterprise invests in or acquires the equity of a resident enterprise in multiple transactions on different dates, and the non-resident subsequently transfers the equity of the resident enterprise, the non-resident should compute its gain based on the transfer price and investment cost in the currency used in its first investment or acquisition of the equity of resident enterprise. If the different currencies are used in the investments or acquisitions, the amounts in subsequent investments or acquisitions

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[15] Article 3 of Guo Shui Han [2010] No. 79.

[16] Article 4(3) of Cai Shui [2009] No. 59.

[17] Article 3 of Guo Shui Han [2009] No. 698.

should be converted in the currency used in the first transaction using the exchange rates on the dates of subsequent investments or acquisitions. Furthermore, the non-resident is required to use the weighted average cost in computing its basis in the equity transferred.[18] The example below illustrates the application of this rule.

A non-resident enterprise N contributed USD500,000 in exchange for 50 percent of equity of a China-resident enterprise C on March 1, Year 1; the remaining 50 percent was owned by another non-resident enterprise F. On May 30, Year 2, N acquired 50 percent of equity of C from F for EUR600,00 when EUR to USD exchange rate was 1.5. On December 31, Year 3, N sold 40 percent of equity of C to a new non-resident buyer B for EUR500,000 when EUR to USD exchange rate was 1.4. N's gain, derived from the sale of 40 percent of equity of C on December 31, 2009, should be computed as follows:

$$\text{Transfer price} = \text{EUR}500{,}000 \times 1.4 = \text{USD}700{,}000$$

$$\text{Tax basis} = (\text{USD}500{,}000 + \text{EUR}600{,}000 \times 1.5) \times 40\% = \text{USD}560{,}000$$

$$\text{Gain} = \text{USD}700{,}000 - \text{USD}560{,}000 = \text{USD}140{,}000$$

The acquisition of stock of an enterprise does not change the existence of the acquired enterprise and merely changes the ownership of the acquired enterprise. Regardless of the percentage of change of ownership, a taxable stock acquisition in principle will not change the CIT attributes or other tax items, such as loss carryovers or credit carryovers, of the acquired enterprise. Although the acquiring enterprise can step up (and sometimes step down) its tax basis in the stock of the acquired enterprise, the tax basis of the acquired enterprise in its assets will remain unchanged. The purchase price in excess of asset basis cannot be depreciated or amortized and the acquiring enterprise can only deduct its tax basis in the stock when it disposes of the stock. The acquisition will not affect the eligibility of tax incentives that the acquired enterprise has been granted. However, if the ownership was the basis for granting such tax incentives, the ownership change may disqualify the enterprise for such tax incentives. For example, suppose a tax holiday was granted for a foreign invested enterprise, which requires a direct foreign ownership of equity of 25 percent or more. If a domestic enterprise acquires 100 percent of stock of the foreign invested enterprise, the acquired enterprise will no longer be eligible for the tax holiday. Under the CIT Law, tax incentives are granted primarily based on the nature of business activities; unified tax incentives are available for both domestic enterprises and foreign invested enterprises. As such, the acquisition of stock generally should not affect the enjoyment of tax incentives of acquired enterprises. However, some tax incentives were granted under FEIT law prior to January 1, 2008 and some of those foreign invested

[18] Article 4 of Guo Shui Han [2009] No. 698.

enterprises continue to enjoy those incentives under a transition rule. The acquisition of stock of those enterprises could result in a disqualification of those tax incentives. All the tax liabilities, including identified and potential liabilities, of the acquired enterprise will remain with the acquired enterprise.

7.4.4 ASSET ACQUISITION

Where an enterprise acquires assets of another enterprise, the acquired enterprise/transferor should recognize gain or loss on the transfer of assets. The gain or loss is the difference between the consideration received by the transferor and the transferor's tax basis in the assets. The tax basis in the assets received by the acquiring enterprise should be determined according to the fair market value of the assets.[19] In an arm's-length transaction, the fair market value should be equal to the consideration paid by the acquiring enterprise. As such, if the acquiring enterprise pays the consideration in cash, the amount of cash in principle should be the basis in the assets acquired; if non-monetary consideration is paid for the assets, the fair market value of the assets paid and the fair market value of the assets acquired should be same.

In an asset acquisition, the acquiring enterprise will not take over tax attributes of the seller. The tax loss carryovers, credit carryovers, and any tax incentives will remain with the seller. Similarly, the acquiring enterprise assumes only the liabilities transferred in the acquisition; it generally will not assume past tax liabilities of the seller. Accordingly, an asset acquisition is a good way to eliminate a buyer's exposure to pre-acquisition tax liabilities of the seller. Another advantage for the buyer in asset acquisition is that the buyer can step up basis in the assets. The purchase price should be allocated to the assets acquired based on the fair market value of the assets. The purchase price in excess of the amount allocated to identifiable assets becomes goodwill. Due to the step-up of basis in identifiable assets, the acquiring enterprise can deduct, depreciate, and/or amortize the tax basis in accordance with tax law and therefore can reduce its taxable income during its post-acquisition operations. On and after January 1, 2008, the acquiring enterprise cannot depreciate or amortize the goodwill on acquisition; it can deduct the tax basis in the goodwill when the enterprise is liquidated or disposes of the entire business.

An asset acquisition often results in higher tax liabilities than those of stock acquisition for the seller. The higher tax liabilities are primarily due to indirect taxes on the transfer of assets. Chapter 7.11 summarizes major indirect taxes in connection with mergers and acquisitions. For CIT purpose, if the selling enterprise is owned by another resident enterprise, the seller will recognize gain or loss on the sale of assets; if the seller distributes the sale proceeds in the form of dividends to the shareholder enterprise, the shareholder

[19] Article 4(3) of Cai Shui [2009] No. 59.

will not need to pay CIT again because dividends paid between resident enterprises are exempted from CIT. However, if the selling enterprise is owned by a non-resident enterprise shareholder, the non-resident enterprise shareholder will be subject to 10 percent withholding tax on the distribution of sale proceeds in the form of dividend by the selling enterprise. Such a tax rate may be reduced by an applicable tax treaty. If the selling enterprise is liquidated after the sale of assets, the liquidation proceeds representing retained earnings of the selling enterprise will be treated as dividends and the remaining amount of distribution in excess of the non-resident enterprise shareholder's tax basis in the stock of selling enterprise will be recognized as gain on transfer of property subject to 10 percent withholding tax.[20] Similarly, if the selling enterprise is owned by individual shareholders, the individual shareholders should be subject to individual income tax at 20 percent of gross dividends distributed by the selling enterprise.[21] Such a tax rate may be reduced by applicable tax treaties for non-resident individual shareholders. Furthermore, a non-resident individual shareholder should be temporarily exempted from individual income tax on dividends paid by a foreign invested enterprise.[22] If the selling enterprise is liquidated after the sale of assets, the liquidation proceeds representing retained earnings of the selling enterprise will be treated as dividends and the remaining amount of distribution in excess of the individual shareholders' tax basis in the stock of selling enterprise will be recognized as gain on transfer of property subject. The tax rate on gain on transfer of property is 20 percent, the same as that on dividend. Accordingly, unless the selling enterprise is owned by resident enterprise shareholders, the asset sales may result in double CIT on the gain derived from the sales. In the situation where the selling enterprise has substantial loss carryovers, it may be advantageous to structure a deal as asset acquisition from CIT perspective. The seller can use its loss carryovers to offset gain on the asset sale and the buyer can step up basis in the assets acquired.

The tax basis in the assets received by the acquiring enterprise is determined based on the fair market value of the assets.[23] This suggests that the purchase price should be allocated to items of assets acquired based on their respective fair market value. However, the CIT Law, the CIT Implementation Rules, and merger and acquisition circulars do not address specific method of allocation of purchase price in an asset acquisition. The accounting standards for business combinations not under the same control provide that the buyer shall allocate the combination costs on the acquisition date to all identifiable assets, liabilities, and contingent liabilities it obtains from the seller. The purchase price

[20] Article 5 of the Notice on Certain Corporate Income Tax Issues Concerning Enterprise Liquidation, Cai Shui [2009] No. 60, issued by the MOF and the SAT on April 30, 2009 and effective on January 1, 2008.

[21] Article 5 of Individual Income Tax Law.

[22] Article 2(8) of Notice on Several Issues Concerning Individual Income Tax Policy, Cai Shui Zi [1994] No. 20, issued by the SAT on May 13, 1994.

[23] Article 4(3) of Cai Shui [2009] No. 59.

in excess of the fair value of the identifiable net assets is recognized as goodwill.[24] The "fair value of the identifiable net assets of the acquiree" refers to the balance of the fair value of the identifiable assets acquired from the acquiree in a business combination minus the fair value of the liabilities and contingent liabilities.[25] According to the guidelines for application of the accounting standards issued by the Accounting Standard Committee of the MOF, the fair market value of identifiable assets and liabilities should be determined based on the following:[26]

(1) The fair market value of a monetary asset is its balance on the books of acquired enterprise on the acquisition date.
(2) The fair market value of financial instruments that are actively traded on market such as stock, bonds, and mutual funds is determined based on the market value on the acquisition date.
(3) The fair market value of short-term receivables generally should be the amount of receivables. The fair market value of long-term receivables should be the present value of amount of receivables discounted by applicable interest rate. When determining the fair market value of receivables, the possibility of bad debt and collection cost should also be considered.
(4) For inventories, the fair market value of finished products and merchandise should be the estimated sale price less estimated selling expenses, applicable tax and fee, and the estimated profits that acquiring enterprise sells similar products. The fair market value of unfinished products should be the estimated sale price of finished products less estimated costs to finish the products, estimated selling expenses, applicable tax and fee, and the estimated profits that acquiring enterprise sells the same or similar products. The fair market value of raw materials should be based on the replacement costs.
(5) The fair market value of financial instruments that do not have an active market, such as equity investment in non-listed companies, can be determined based on valuation techniques. The valuation method should be able to reflect the transaction prices that may be adopted in fair dealings on the valuation day. The valuation techniques mainly include the prices adopted in the latest market transactions, the current fair value obtained by referring to other financial instruments of the same essential nature, the discounted cash flow method, and the option pricing model.

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[24] Article 13 of Accounting Standards for Enterprises No. 20 - Business Combinations, Cai Kuai [2006] No. 3, issued by the MOF on February 15, 2006.

[25] Article 14 of Accounting Standards for Enterprises No. 20.

[26] Guidelines for Application of Accounting Standards for Enterprises No. 20–Business Combination, issued by Accounting Standard Committee of the MOF on December 30, 2006 and effective on January 1, 2007 (mandatory applying to public companies only).

(6) For buildings, equipment, and intangible assets, if there is an active market, their fair market value should be determined based on such market value on the acquisition date; if there is no active market, the fair market value should be determined by referring to same category or similar category of assets that have an active market. If there is no active market for the same or similar category of assets, the fair market value can be determined based on valuation.
(7) Among account payables, notes payables, salary payables, bond payables, and long-term payables, the fair market value of short-term liabilities generally should be determined based on the amount of payables; the fair market value of long-term liabilities should be the present value of the book amount applying appropriate discount rate.
(8) For contingent liability acquired, if the fair market value of contingent liability can be reliably measured on the acquisition date, the liability should be estimated based the amount that a third party would have paid if such party were to assume such liability.
(9) The fair market value of deferred tax assets and liabilities should be the difference between the fair market value of identifiable assets and liabilities and contingent liabilities and the tax basis of the assets and liabilities.

It is common practice that in the absence of specific treatment under the CIT Law and regulations, accounting treatment can be used as reference. The parties to the asset acquisition may also engage an independent appraiser to provide asset valuation to support their purchase price allocation.

7.4.5 MERGER

A taxable merger is treated as liquidation for both the merged enterprise and the shareholders of the merged enterprise.[27] In this deemed liquidation, the merged enterprise should recognize gain or loss on transfer of its assets based on cashable value or transaction price of its assets.[28] The Company Law authorizes two types of merger, an absorption merger and a newly established merger or dissolution merger. In an absorption merger, one company absorbs another company and the merged company is dissolved; in a newly established merger or dissolution merger, two or more companies combine to establish a new company, and the existing companies are dissolved.[29]

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[27] Article 4(4)(2) of Cai Shui [2009] No. 59.
[28] Article 3 of Cai Shui [2009] No. 60.
[29] Article 173 of Company Law.

Suppose Company B merged into Company A with Company A as a surviving company. Immediately before the merger, the relevant data is as follows:

	Company A (RMB)	Company B (RMB)
Book value/tax basis of net assets	300	100
Market value	400	200
Retained earnings	100	40
Shareholders' tax basis in equity	250	60
Total number of shares outstanding	400	100

In the merger, Company B transferred all of its assets and liabilities to Company A; the shareholders of Company B surrendered their shares of Company B in exchange for 160 shares of Company A and RMB40 in cash (i.e., the consideration of 80 percent in stock and 20 percent in cash).

This is an example of an absorption merger. First, Company B is deemed to be liquidated. Company B should recognize RMB100 of gain (RMB200 market value–RMB100 basis) and pay RMB25 of CIT (RMB100 x 25%). Second, Company B's shareholders are deemed to receive RMB175 (RMB200 less CIT RMB25) of distribution at the deemed liquidation. Of this amount, RMB60 is return of capital and RMB115 is dividend. If Company B's shareholders are resident individuals, they will need to pay RMB23 of individual income tax (RMB115 x 20%). Finally, Company A's tax basis in Company B's assets is RMB200. According to the merger tax rules, the tax basis of each asset and liability received is determined based on fair market value.[30]

Suppose the facts are the same as in the above example, but instead of Company B merging into Company A, Company A and Company B are merged into a newly established Company C by transferring all of their assets and liabilities into C; Company A and Company B are then dissolved. In this newly established merger, Company A and Company B both are deemed to be liquidated. In this example, the tax treatments of Company B and Company B's shareholders are the same as that in the absorption merger. The tax treatments of Company A and Company A's shareholders are similar to those of Company B and Company B's shareholders. Specifically, Company A will recognize RMB100 (RMB400–RMB300) of gain and pay RMB25 (RMB100 x 25%) of CIT; the shareholders of Company A will recognize RMB125 (RMB400–RMB25 CIT–RMB250 basis) of dividend income. The tax basis of Company C in the assets received from Company A and Company B will be RMB600.

[30] Article 4(4)(1) of Cai Shui [2009] No. 59.

In two examples above, we have assumed that neither Company A nor Company B has loss carryovers. If Company B has loss carryovers in the absorption merger example, Company B can use the loss to offset the gain on deemed liquidation. Similarly, in the newly established merger, both Company A and Company B can use their respective losses to offset their respect gains. However, unutilized losses of merged company cannot be transferred to surviving company.[31]

The tax treatment of a taxable merger is very similar to that of taxable asset acquisition because the merged enterprise is treated as if it had sold all assets at the deemed liquidation. However, there are differences between them.

First, in an asset acquisition, the selling entity can transfer all or only portion of its assets and liabilities to the acquiring enterprise; thus the selling entity does not have to be liquidated after the asset sale. If the selling enterprise sells all of its assets and then liquidates the company, it must go through formal liquidation procedures. In a taxable merger, the merged entity must transfer transfers all of its assets and liabilities to the surviving entity. Although there is a deemed liquidation for CIT purpose, there is no actual legal liquidation. The merged entity does not need to go through liquidation procedures. However, if the merged entity is converted from a company to a branch of the surviving entity, the company must be de-registered with the tax authorities and the branch must then be registered with the tax authorities.

Second, in an asset acquisition, the acquiring company generally does not inherit the tax liabilities of selling company. In a merger, the surviving company or the newly established company will assume all the liabilities of merged companies.[32] As such, although the merged company is deemed liquidated for CIT purposes, the tax authorities can seek to recovery unpaid taxes of the merged company from the surviving or newly established enterprise.

7.4.6 DE-MERGER

A de-merger is a reverse of merger. A single enterprise (the original enterprise) is separated into two or more enterprises. The transfer of assets by the original enterprise to a spin-off enterprise is treated as a sale of assets at fair market value by the original enterprise; the original enterprise should recognize gain or loss on the deemed sale. The tax basis of the spin-off enterprise in its assets is equal to the deemed purchase price (i.e., the fair market value) of the assets. If the original enterprise continues to exist, the consideration received by the shareholders of the original enterprise is treated as a distribution. If the original enterprise ceases to exist, it is treated as having been liquidated.[33]

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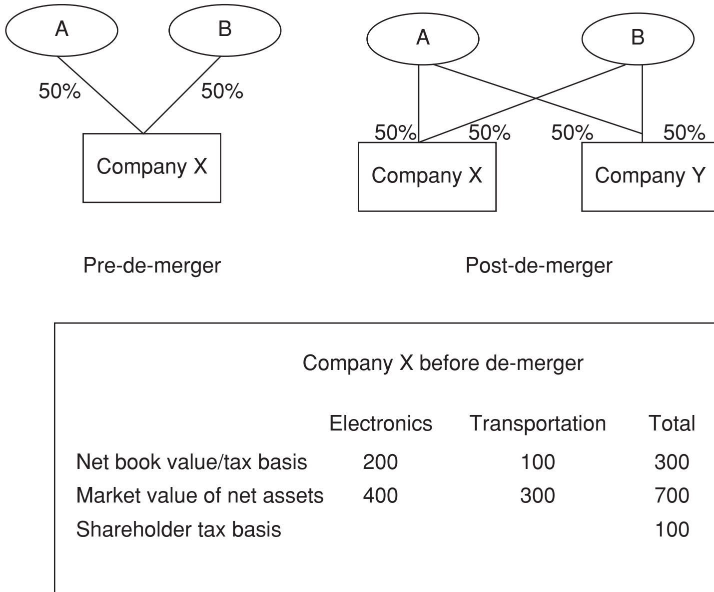
[31] Article 4(4)(3) of Cai Shui [2009] No. 59.

[32] Article 175 of Company Law.

[33] Article 4(5) of Cai Shui [2009] No. 59.

Suppose Company X engages in both electronics manufacturing and transportation business. Company X transfers its transportation business to a newly established Company Y. A and B, Company X's shareholders, receive shares of Company Y. The transaction is diagrammed in Figure 7.4.6-1:



Company X before de-merger

	Electronics	Transportation	Total
Net book value/tax basis	200	100	300
Market value of net assets	400	300	700
Shareholder tax basis			100

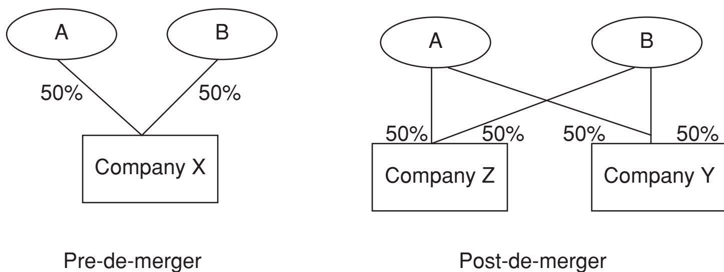
FIGURE 7.4.6–1

Assume the transaction does not meet the requirements of special reorganization or the parties did not elect to treat the transaction as a special reorganization, the de-merger tax rule for ordinary reorganizations will apply. Company X is treated to sell the transportation business to Company Y for 300 and thus should recognize RMB200 (RMB300 market value –RMB100 basis) of gain. Assuming the applicable CIT rate is 25%, Company X should pay RMB50 (RMB200 x 25%) of CIT. Company Y will step up basis to RMB300 in the assets received. Shareholders A and B are treated to receive a distribution of shares of Company Y from Company X. The tax rule does not address the character of the deemed distribution. Presumably, the value of the shares of Company Y should be treated as dividends to the extent of accumulated earnings and profits (including the gains on the deemed sale) of Company X; the value in excess of the retained earnings logically would be treated as a return of capital up to the shareholders' tax basis. Let's assume the de-merger itself does not increase or decrease the value of each business. As such, the shares of Company Y should be valued at RMB300 immediately after the de-merger without considering CIT. The question is who will pay RMB50 of CIT on the deemed sale. If Company X pays the CIT out of cash maintained for electronics business, the value of Company Y will remain RMB300 after the de-merger and after considering CIT liability. In such case, A and B should be treated as receiving 300 of dividends assuming

Company X's retained earnings are no less than RMB300. However, if under the de-merger agreement, the RMB50 CIT is borne by transportation business (e.g., the cash transferred to Company Y will be reduced by RMB50), the value of Company Y should be reduced by such tax liability, assuming such liability was not reflected in RMB300 of valuation. In such case, A and B will be treated as receiving RMB250 of dividends.

The de-merger rule provides that the loss of an enterprise cannot be used by another enterprise.[34] It is not clear how this rule will apply to a de-merger. As the de-merger is considered a sale of assets, logically the tax losses of the original enterprise should be retained in the original enterprise. Suppose that in our example above, Company X had a tax loss carryover of RMB250. In that case, Company X will not have CIT payable on the deemed sale because the gain will be fully offset by the loss carryover. The remaining RMB50 of loss carryover, however, cannot be used by Company Y. The loss carryover should be retained by Company X and can be used by Company X in the post-de-merger years within the valid loss carryover period.

Suppose the facts are the same as the example above except Company X transfers transportation business and electronics business to Company Y and Company Z, respectively, and Company X will be dissolved. The transaction is diagrammed in Figure 7.4.6-2:



Company X before de-merger

	Electronics	Transportation	Total
Net book value/tax basis	200	100	300
Market value of net assets	400	300	700
Retained earnings			150
Shareholder tax basis			100

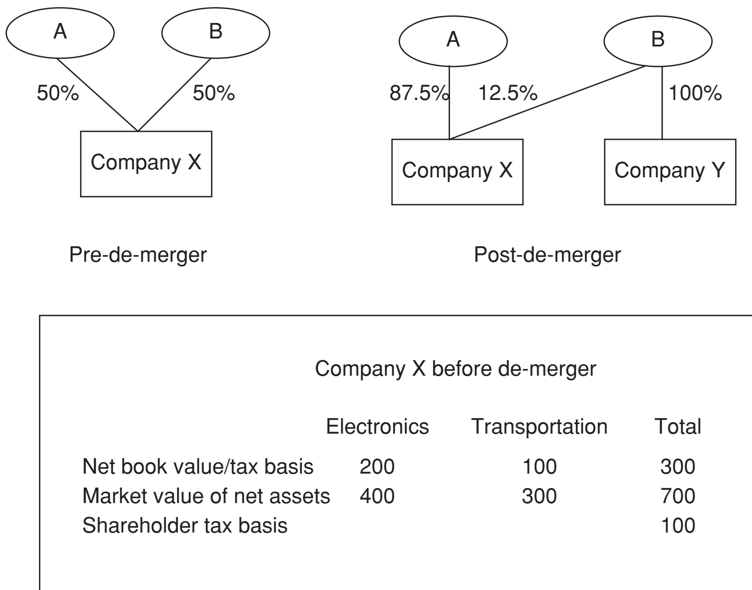
FIGURE 7.4.6–2

In such case, Company X will be treated as selling the entire business at RMB700 and will recognize RMB400 (RMB700 market value–RMB300 basis) of gain. Company Y's

[34] Article 4(5)(5) of Cai Shui [2009] No. 59.

tax basis in the assets received will be RMB300; Company Z's tax basis in the assets received will be RMB400. Company X is treated as liquidated and A and B should be treated as receiving a distribution of RMB600, i.e., RMB700 less RMB100 of CIT paid by Company X. Of this RMB600, RMB450 is dividend (RMB400 gain on deemed sale –100 CIT + 150 other retained earnings), RMB100 is the return of capital, and RMB50 is the gain on transfer of property.

In the two examples above, the shareholders of the original enterprise receive stocks of the spin-off enterprises in proportion to their original ownership in the original enterprise. In our previous examples, A and B each owns 50 percent of the original enterprise as well as 50 percent of each post-de-merged enterprises. Such proportional ownership is not required for ordinary reorganizations. The Company Law does not require that all shareholders of the original enterprise be shareholders of the spin-off or split-off enterprise. Suppose Company X transfers transportation business to Company Y. However, B will reduce his ownership in Company X and receive all shares of Company Y. The transaction is diagramed in Figure 7.4.6-3:



Company X before de-merger

	Electronics	Transportation	Total
Net book value/tax basis	200	100	300
Market value of net assets	400	300	700
Shareholder tax basis			100

FIGURE 7.4.6–3

Company X is treated to sell the transportation business to Company Y for RMB300 and thus should recognize RMB200 (RMB300 market value – RMB100 basis) of gain. Company Y will step up basis to RMB300 in the assets received. The tax treatment of shareholders is not clear in this situation. There are two possible solutions.

One solution is to treat B as redeeming 75 percent of his equity in Company X in exchange for 100 percent equity of Company Y. Assuming B's tax basis in shares of Company X is

RMB50, his basis in the RMB75 percent equity surrendered should be RMB37.5. Thus, B may have RMB262.5 (RMB300 – RMB37.5) of gain on transfer of property. This amount of again should be adjusted if CIT paid by Company X is borne by transportation business (e.g., the cash transferred to Company Y will be reduced) and the value of Company Y is therefore reduced. The capital gain treatment to B does not seem consistent with "distribution from enterprise" treatment as provided in the de-merger tax rule. The full RMB300 could be treated as dividends; B's tax basis in Company X would remain RMB50. Alternatively, B could be treated as receiving RMB262.5 of dividend; B's tax basis in Company X would be reduced to RMB12.5 (RMB50 – RMB37.5). The character of income as capital gain or dividend is not important for resident individual shareholders, as the tax rate is same for both types of income. Such characterization may be important to resident enterprise shareholders as the tax treatments for dividends and gain on transfer of property are different for them.

Another possible solution is to treat the transaction as two steps. In step one, Company X transfers the transportation business to Company Y, and A and B each receives 50 percent of all outstanding shares of Company Y. In step two, A transfers 50 percent of Company Y to B in exchange for 37.5 percent of Company X from B. The CIT treatment of step one would be the same as the first example of de-merger discussed above. Company X should recognize a gain on the transfer of assets to Company Y; A and B will be treated as receiving distribution from Company X. Let's assume A and B each is deemed to receive shares of Company Y with a value of RMB150. In step two, each A and B would recognize gain or loss on the shares exchange. Assuming the value of Company X after the de-merger is RMB400, 37.5 percent of Company X should be RMB150. As A's tax basis in 50 percent equity of Company Y is RMB150, A should not have any gain or loss in step two of the transaction. B's tax basis in 37.5 percent equity of Company X is RMB37.5; B should have RMB112.5 (RMB150 – RMB37.5) of gain on transfer of property. For illustration purposes, we have not adjusted the value of each company for CIT paid by Company X in step one.

The tax result for Company X and Company Y in both solutions is identical. For shareholders, in the first solution, only B is taxed on the transaction; in the second solution, both A and B will be taxed on the transaction. As the regulations do not offer any guidance, the tax treatment on specific transactions will be subject to the interpretations of tax authorities in charge.

One issue is who will be responsible for potential tax liabilities incurred by the original enterprise prior to the de-merger. The tax rules do not address this question. Company Law provides that the post-de-merger companies jointly liable for pre-de-merger liabilities of the original company unless otherwise provided in the written agreement between the original company and the creditor prior to the de-merger.[35] According to this provision,

[35] Article 177 of Company Law.

if there is an underpayment of taxes for the period prior to the de-merger, the tax authorities can seek recovery of taxes, interest and penalties from all or any of the post-de-merger entities. In practice, if the original enterprise exists after the de-merger, the tax authorities most likely will go after the original enterprise first, as the enterprise is the same legal person as prior to the merger. However, the tax authorities could seek recovery from the spin-off enterprises. In the situation where the original enterprise ceases to exist as a result of a de-merger, the tax authorities can seek recovery of tax, interest, and penalties from the new post-de-merger enterprises. When the original enterprise is dissolved, it will need to de-register with the tax authorities. In the tax-de-registration process, the tax authorities will review the tax filing information of the original enterprise and may perform a tax audit. If the tax authorities find any underpayment of taxes of the original enterprise, the tax authorities will request that the enterprise settle the taxes, late payment charges, and penalties, if any, prior to completion of tax de-registration.

7.4.7 DOCUMENTATION AND FILING REQUIREMENTS

7.4.7.1 Change of Legal Form

A company should file Corporate Income Tax Return on Liquidation when the company is converted into a sole proprietorship, partnership, or other non-legal person organization, or reincorporated in a foreign country or region. With the liquidation tax return filing, the enterprise should submit the following documents:[36]

(1) The approval document issued by the relevant office of administration for industry and commerce or other government office concerning the change of legal form;
(2) The tax basis of the enterprise in all of its assets and the asset valuation report issued by a PRC licensed appraiser;
(3) The statement of succession of credit and debt of the enterprise; and
(4) Other information that may be required by the tax bureau in charge.

7.4.7.2 Debt Restructuring

In a debt restructuring, the enterprise should prepare the following documents. However, those documents are not required to be submitted to the tax authorities; instead, they should be kept by the enterprise for the inspection of the tax authorities.[37]

[36] Article 10 of SAT Gong Gao 2010 No. 4.

[37] Article 11 of SAT Gong Gao 2010 No. 4.

(1) If a debt is settled with a non-monetary asset, the enterprise should maintain the debt settlement agreement signed by the parties and the valid evidence of fair market value of the non-monetary asset.
(2) If the debt is converted into equity, the enterprise should maintain the agreement of debt to acquisition conversion signed by the parties.

7.4.7.3 Stock or Asset Acquisition

In a stock acquisition or an asset acquisition, the enterprise should prepare the following documents. However, those documents are not required to be submitted to the tax authorities; instead, they should be kept by the enterprise for the inspection of the tax authorities.[38]

(1) The share purchase agreement or asset purchase agreement signed by the parties; and
(2) The valid evidence of fair market value of the stock or asset.

7.4.7.4 Merger

In a merger, the merged enterprise should file Corporate Income Tax Return on Liquidation together with the following documents:[39]

(1) The approval document issued by the relevant office of administration for industry and commerce or other government office concerning the merger;
(2) The tax basis of the enterprise in all of its assets and liabilities, and the asset valuation report issued by a PRC licensed appraiser;
(3) The statement of succession of credit and debt of the enterprise; and
(4) Other information that may be required by the tax bureau in charge.

7.4.7.5 De-merger

In a de-merger, if the de-merged enterprise ceases existence, the de-merged enterprise should file Corporate Income Tax Return on Liquidation together with the following documents:[40]

(1) The approval document issued by the relevant office of administration for industry and commerce or other government office concerning the de-merger;

[38] Article 12 of SAT Gong Gao 2010 No. 4.
[39] Article 13 of SAT Gong Gao 2010 No. 4.
[40] Article 14 of SAT Gong Gao 2010 No. 4.

(2) The tax basis of the enterprise in all of its assets and the asset valuation report issued by a PRC licensed appraiser;
(3) The statement of succession of credit and debt of the enterprise; and
(4) Other information that may be required by the tax bureau in charge.

7.5 Special Reorganization

A special reorganization allows taxpayers to defer gain recognition in full or part derived from a transaction. A special reorganization is an election of taxpayers subject to required conditions. When those conditions are met, the taxpayers may choose to treat a transaction as an ordinary reorganization or a special reorganization.

7.5.1 COMMON REQUIREMENTS TO QUALIFY AS SPECIAL REORGANIZATION

A special reorganization must meet all of five general conditions:

(1) Bona fide business purpose. The transaction must have a bona fide business purpose and its primary purpose must not be to reduce, avoid, or defer tax payments.[41] This condition is consistent with the general anti-avoidance rules as provided in the CIT Law and the CIT Implementation Rules where transactions must have a reasonable commercial purpose. However, the tax law and regulations do not provide specific guidance on the determination of business purposes. Nor are there any judicial or administrative interpretations. It is unclear what level of commercial reasons for a transaction would constitute primary business purpose. For example, where a reorganization is undertaken for both valid business purposes and tax avoidance purposes, it is not clear whether the business purpose requirement is satisfied. Furthermore, if a reorganization is undertaken for valid commercial reasons, whether specific arrangement taken to avoid recognition of taxable gain would be considered as a step taken to "avoid or defer tax payments." Financially, it is not clear whether business purpose is only at the corporate level or if the valid shareholder-level business purpose suffices. In spite of those unclarities, the SAT provides the following guidance to the preparation of bona fide business purpose explanations, to be submitted to the tax authorities:[42]

[41] Article 5(1) of Cai Shui [2009] No. 59.
[42] Article 18 of SAT Gong Gao 2010 No. 4.

(i) The enterprise should describe the method of reorganization, including the forms of reorganization, the background of transaction, the time of transaction, and the operation models before and after the reorganization.
(ii) The enterprise should explain the form and substance of reorganization, including the legal right and obligation as a result of the reorganization as well as the final actual and commercial result of the transaction.
(iii) The enterprise should describe the possible changes of tax status of the parties to the reorganization as a result of the transaction.
(iv) The enterprise should state the changes of financial status of the parties to the reorganization as a result of the transaction.
(v) The enterprise should provide whether the reorganization results in any economic benefits or potential obligations to the parties that otherwise would not be obtained under free market principle.
(vi) The enterprise should provide information of non-residents' participation in the reorganization, if any.

These guidelines are helpful for a taxpayer to prepare the business purpose statement; however, the determination as to whether an reorganization satisfies bona fide business purpose requirements will be subject to the interpretation of the tax rules by the tax authorities.

(2) Ratios on amount of assets transferred. The assets or stock transferred in the acquisition, merger, or de-merger must satisfy the ratios prescribed by the special reorganization tax rule.[43] The required ratios are at least 75 percent of total assets or equity in an acquisition of asset or stock and 100 percent assets in mergers.
(3) Continuity of business. There must be no substantial change in business activities with respect to the assets involved in a reorganization within 12 months of the date of reorganization.[44] The objective of the special reorganization rules is to allow business to be operated under modified corporate form without immediate recognition of gain or loss and thus tax will be neutral in the business arrangement. For this reason, the acquiring enterprise must continue the historical business of the acquired enterprise. In practice, it may be difficult to determine whether there is a substantial change of business, as changes are often needed to respond to the market needs. For example, Company A acquires all assets of Company B with two lines of business. Company A continues and expands one line of formal business of Company B after the acquisition. However, Company A abandons the other line of business due to obsolete technology. Will this

[43] Article 5(2) of Cai Shui [2009] No. 59.
[44] Article 5(3) of Cai Shui [2009] No. 59; Article 19 of SAT Gong Gao 2010 No. 4.

abandonment constitute a substantial change of business? The economic argument can be made that such change of business should not disqualify the special reorganization treatment. Nevertheless, further guidance may be needed from the tax regulations or judicial and administrative interpretations.

(4) Consideration in equity. The payment in stock as a percentage of total consideration for the transaction must be within the ratio prescribed by the special reorganization tax rule.[45] This prescribed ratio requires that in a stock acquisition, an asset acquisition, a merger, and a de-merger, at least 85 percent of the total consideration paid by acquiring enterprise to acquired enterprise be in form of stock.

(5) Continuity of interest. The former major shareholders who receive stock as consideration in a special reorganization must not transfer the stock within 12 months of the date of reorganization.[46] The purpose of the requirement is to ensure some level of continuity on the part of former shareholders of the acquired enterprise in the post-transaction enterprise and to ensure that the reorganization is not merely a tool for the former shareholders to exit from the business. A "former major shareholder" for this purpose is a shareholder who held 20 percent or more of the transferring enterprise or acquired enterprise.[47] It is not clear who is the "former major shareholder of the transferring enterprise." Suppose Company A owns 100 percent of Company B; Company B owns 100 percent of Company C. In an asset acquisition, if C transfers 75 percent of C's asset to Company D in exchange for D's stock, the transferring enterprise should be C. Although B owns 100 percent of C, B should not be a "former major shareholder" because B did not receive D's stock. B could only be a "former major shareholder" if D issues D's stock to B as a consideration for the transfer of assets by C, which does not seem to be permitted in a special reorganization. If in a stock acquisition, B transfers 80 percent of C's stock to D in exchange for D's stock, B should be a "former major shareholder" because B held more than 20 percent of C, the transferred enterprise. However, is A also a "former major shareholder" because A owns more than 20 percent of B, the transferring enterprise?

7.5.2 DEBT RESTRUCTURING

If a debt restructuring satisfies the requirements for a special reorganization and the taxable income recognized as a result of the debt restructuring is more than 50 percent of the current year's taxable income, the debt-restructuring income can be recognized in equal

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[45] Article 5(4) of Cai Shui [2009] No. 59.

[46] Article 5(5) of Cai Shui [2009] No. 59.

[47] Article 20 of SAT Gong Gao 2010 No. 4.

installments for five years. However, for a conversion of debt into equity, gain or loss on debt settlement and investment may not be recognized; the tax basis of the original creditor in the stock received should be equal to its tax basis in the debt so exchanged and cancelled.[48]

It is not clear what type of debt restructuring is qualified as a special reorganization. There are five general requirements for a special reorganization. However, some of those do not seem applicable to a debt restructuring. The first requirement is bona fide business purpose. By definition, a debt restructuring is an arrangement between a debtor and its creditors relating to debts as a result of financial difficulties of the debtor where certain concessions are made by creditors based on a written agreement between the parties or a court decision. It appears that any bona fide debt restructuring should satisfy business purpose. The second requirement is asset transfer ratio, which only applies to acquisitions, mergers and de-mergers. The third requirement is the continuity of business, which would require that the debtors do not substantially change in business activities within 12 months of the reorganization. It is common that as part of a debt restructuring, the debtor is required to make certain changes in its business in order to improve its financial conditions. Those changes probably will not constitute "substantial change of business." The fourth requirement is equity payment ratio. This requirement should not be applicable to debt restructurings as the 85 percent of consideration in equity is only required in asset acquisition, stock acquisition, merger and de-merger. The fifth requirement is that the major shareholders of acquired enterprise cannot transfer shares received in the reorganization within 12 months after the transaction. This requirement should not be applicable to a debt restructuring as there is no acquired enterprise and creditors (who may receive shares of the debtor) are not the former shareholders of such enterprise. Accordingly, it appears that any bona fide debt restructuring generally should be qualified as a special reorganization. However, it is not clear whether the tax authorities will share the same view.

Suppose Company D is having financial difficulties and has reached an agreement with creditors for a debt restructuring. Before the debt restructuring, the relevant financial information of Company D is as follows:

	Net book value/tax basis	Market value
Assets excluding Building X	1000	600
Building X	*100*	*400*
Total assets	1100	1000
Loan from Bank A (secured by Building X)	1000	
Loan from Bank B	500	
Shareholder equity	*(400)*	
Total liability and equity	1100	
Unexpired tax loss carryover	550	
Current year loss	100	

[48] Article 6(1) of Cai Shui [2009] No. 59; Article 19 of SAT Gong Gao 2010 No. 4.

According to the debt restructuring agreement, Company D will transfer Building X to Bank A in full settlement of the loan from Bank A, and issue 1000 shares of Company D to Bank B in exchange for cancellation of the loan from Bank B.

With respect to the arrangement with Bank A, Company D will have a gain of RMB300 (RMB400 Building X market value– RMB100 tax basis) on transfer of Building X and a debt forgiveness income of RMB600 (RMB1000 debt – RMB400 Building X market value). For illustration purpose, we will disregard any transfer taxes.

Income from Building X transfer	300
Income from Cancellation of Bank A loan	600
Other income (loss)	*(100)*
Taxable income before NOL utilization	800
Loss carryovers from prior years	*(550)*
Taxable income	250

It is not crystal clear under the mergers and acquisitions tax rules whether the debt restructuring income is the RMB600 of debt forgiveness income only or both the debt forgiveness income and the gain on deemed property sale. As both are related to the debt restructuring, logically the debt restructuring income should include both. It is also not clear whether the current year taxable income is taxable income before or after utilization of loss carryovers from prior years. In our example, the taxable income from debt restructuring is more than 50 percent of current year taxable income regardless of how current year taxable income is defined. As such, the five-year income recognition deferral rule should apply. Company D should recognize RMB50 as taxable income (i.e., one-fifth of RMB250) in current year and RMB50 each year for next four years.

With respect to the conversion of Bank B loan into equity, if the parties elect special reorganization treatment, Bank B should not recognize gain or loss; Bank B's tax basis in 1000 shares of Company C received should be equal to its original tax basis in the loan, RMB1,000. Company D will not recognize income or loss on the cancellation of debt.

7.5.3. STOCK-TO-STOCK TRANSACTION

In an equity acquisition, if the transaction satisfies all of the general requirements for a special recognition and at the same time, and if (1) the acquiring enterprise acquires 75 percent or more of the stock of the acquired enterprise and (2) the payment in stock is no less than 85 percent of the total consideration for the acquisition, then the parties can elect to treat the equity acquisition as a special reorganization.[49] The shareholders of

[49] Article 6(2) of Cai Shui [2009] No. 59.

the acquired enterprise do not recognize gain or loss on the stock exchange;[50] their tax basis in the stock received should be determined based on their tax basis in the stock surrendered.[51] The tax basis of the acquiring enterprise in the stock of the acquired enterprise should be the same as the original tax basis of the acquired enterprise stock.[52] The tax basis of the assets and other tax matters of both enterprises remain unchanged.[53] The example in Figure 7.5.3-1 illustrates an equity acquisition in a special reorganization.

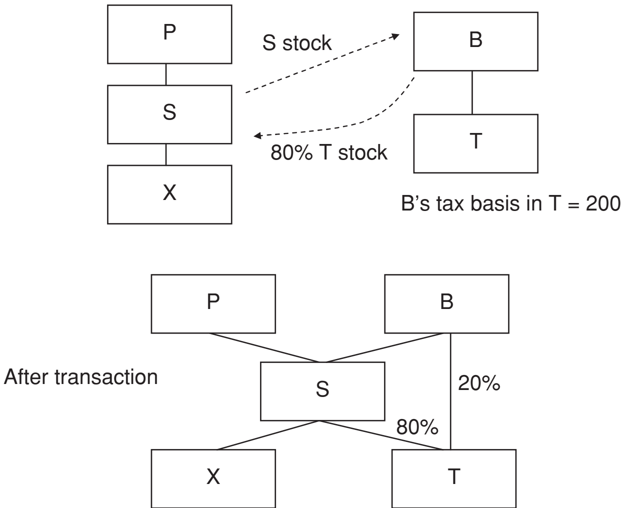

FIGURE 7.5.3–1

S issues its shares to B in exchange to 80 percent equity of T. Neither S nor B recognizes gain or loss on the shares exchange. B's tax basis in S is RMB160. S's tax basis in T stock is RMB160. The reorganization tax circular defines the stock used as payment as the stock of the acquiring enterprise or the stock of its controlled enterprise.[54] Accordingly, S can pay B either S stock or X stock as consideration for the acquisition. However, it appears that S cannot use P stock as a payment in a special reorganization. If P stock is issued to B in the reorganization, P stock will not be treated as stock for the purpose of qualification for special reorganization; P stock will be treated as boot. If P is a publicly listed company, it is often desirable to issue P stock, instead of S stock, to B. In such situation, if the parties intend to treat the transaction as a special reorganization, P can acquire

[50] Article 6(6) of Cai Shui [2009] No. 59.

[51] Article 6(2)(1) of Cai Shui [2009] No. 59.

[52] Article 6(2)(2) of Cai Shui [2009] No. 59.

[53] Article 6(2)(3) of Cai Shui [2009] No. 59.

[54] Article 2 of Cai Shui [2009] No. 59.

T directly. However, P may have several lines of business and S may be the parent company controlling one line of business. For commercial reasons, it may be desirable to have S own T and P issue P stock to B. Hopefully, additional tax circulars can be issued to clarify and allow such arrangements in a special reorganization.

One possible solution is to arrange a two-step transaction as illustrated in Figure 7.5.3-2. Step One, P acquires stock of T. Step Two, S acquires T stock from P.

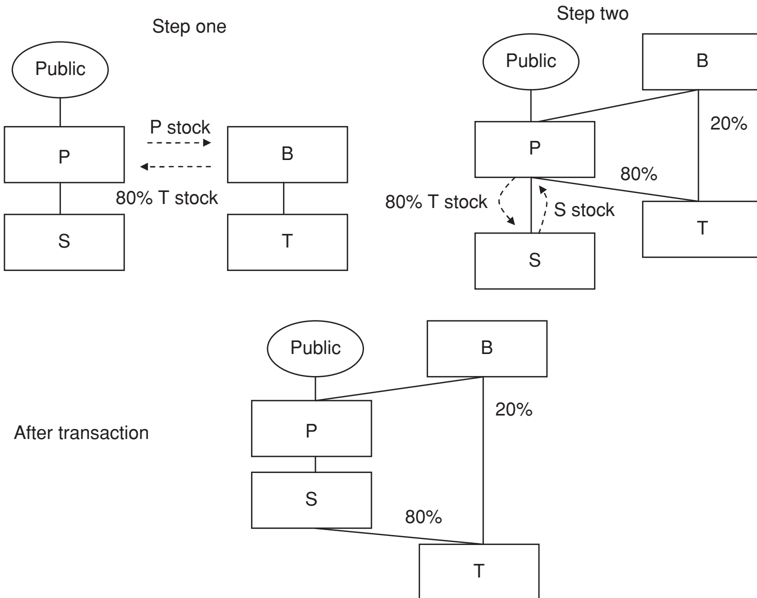

FIGURE 7.5.3–2

Step One should be qualified as a special reorganization, as P will acquires 80 percent of T stock, and 100 percent of consideration paid to B will be P stock. Step Two should also be qualified as a special reorganization as S will acquires 80 percent of T stock and 100 percent of consideration paid to P will be S stock. The 12-month holding requirement in general conditions for special reorganization is only applicable to major former shareholders of the acquired enterprise, here B. P's transfer of T stock within 12 months after Step One should not disqualify Step One as a special reorganization. One possible issue is whether the tax authorities will view the two steps as one transaction based on step transaction doctrine. See discussion for step transaction in Chapter 7.5.9. If they are treated as one reorganization, the transaction could be viewed as an acquisition of T stock by S in issuing P stock. As P stock may not be qualified stock in a special reorganization, the transaction would not qualify for a special reorganization. Again, there are sufficient commercial reasons for the parties to structure this type of transaction and such arrangement would not reduce or refer any CIT compared to S's issuing S stock for T stock. As such, there should be no policy reason against such arrangement.

7.5.4 STOCK FOR ASSET TRANSACTION

In an asset acquisition, if the transaction satisfies all of the general requirements for a special recognition and at the same time, (1) the acquiring enterprise acquires 75 percent or more of total assets of the acquired enterprise and (2) the payment in stock is no less than 85 percent of the total consideration for the acquisition, then the parties can elect to treat the equity acquisition as a special reorganization.[55] In such case, no gain or loss will be recognized for the parties with respect to the stock consideration.[56] The tax basis of the asset transferor in the stock received should be determined based on their tax basis in the assets transferred.[57] The tax basis of the acquiring enterprise in the assets acquired should be the same as the original tax basis of the transferor in the assets.[58] The example in Figure 7.5.4-1 illustrates an asset acquisition in a special reorganization.

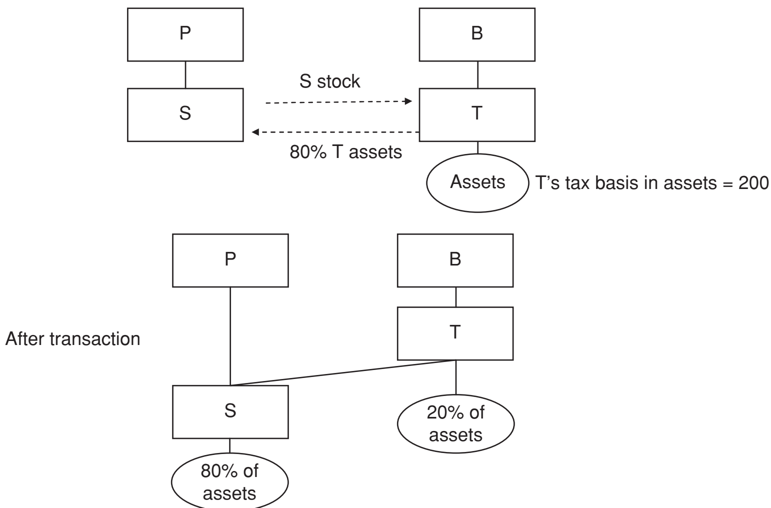

FIGURE 7.5.4–1

S issues its shares to T in exchange to 80 percent of assets of T. Neither S nor T recognizes gain or loss on the stock for asset exchange. Assuming T's basis in the assets transferred to S is RMB160 (80% of RMB200), T's tax basis in S stock is RMB160. S's tax basis in the assets received is RMB160. The reorganization tax circular defines the stock used as payment for the stock of the acquiring enterprise or the stock of its controlled enterprise.[59] Accordingly, S can pay T in S stock or stock of S's subsidiary as consideration for the acquisition. However,

[55] Article 6(3) of Cai Shui [2009] No. 59.

[56] Article 6(6) of Cai Shui [2009] No. 59.

[57] Article 6(3)(1) of Cai Shui [2009] No. 59.

[58] Article 6(3)(2) of Cai Shui [2009] No. 59.

[59] Article 2 of Cai Shui [2009] No. 59.

it appears that S cannot use P stock as a payment in a special reorganization. If P stock is issued to T in the reorganization, P stock will not be treated as stock for purpose of qualification for special reorganization; P stock will be treated as boot. If P is a publicly listed company, it is often desirable to issue P stock, instead of S stock. Hopefully, additional tax circulars can be issued to clarify and allow such arrangements in a special reorganization.

Furthermore, the special reorganization tax rule does not seem to allow S to issue stock to B. Suppose after the asset acquisition, T is liquidated by distributing all the assets, including S stock, to B. Such liquidation will disqualify the special reorganization treatment of S's acquisition of T assets because T transfers stock received within 12 months after the reorganization. T can make such stock transfer after the12-month holding period. However, T will have to recognize gain or loss on the distribution of S stock to B.

7.5.5 MERGERS

A merger requires that one or more enterprises transfer its entire assets and liabilities to another enterprise. If a merger satisfies all of the general requirements for a special recognition and at the same time, (1) the stock consideration received by the shareholders of the merged enterprises is 85 percent or more of the total consideration or (2) no consideration is paid because of common control, then the parties can elect to treat the merger as a special reorganization.[60] In such a case, the merged enterprises and their shareholders will not recognize gain or loss with respect to the asset transfer and stock consideration received.[61] The tax basis of the surviving enterprise in the assets and liabilities received should be determined based on the tax basis of those assets and liabilities at the hand of the merged enterprises immediately before the transfer.[62] The surviving enterprise generally will assume the tax attributes and other relevant tax items of the merged enterprises.[63] The tax basis of the shareholders of the merged enterprises in the stock of the surviving enterprise received should be determined according to the stock of the merged enterprises originally held.[64] However, the use of loss carryovers of the merged enterprises by the surviving enterprise is subject to a limitation. The limitation is an amount equal to the fair market value of the net assets of the merged enterprises, multiplied by the interest rate of the longest-term treasury bond that has been issued by the end of the year in which the merger takes place.[65] The SAT clarifies that this is an annual limitation and

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[60] Article 6(4) of Cai Shui [2009] No. 59.

[61] Article 6(6) of Cai Shui [2009] No. 59.

[62] Article 6(4)(1) of Cai Shui [2009] No. 59.

[63] Article 6(4)(2) of Cai Shui [2009] No. 59.

[64] Article 6(4)(4) of Cai Shui [2009] No. 59.

[65] Article 6(4)(3) of Cai Shui [2009] No. 59.

that the surviving enterprise can use the tax loss carryovers of the merged enterprise up to the limitation amount each year for the remaining loss carryover period of such losses.[66]

Example 1: Absorption Merger

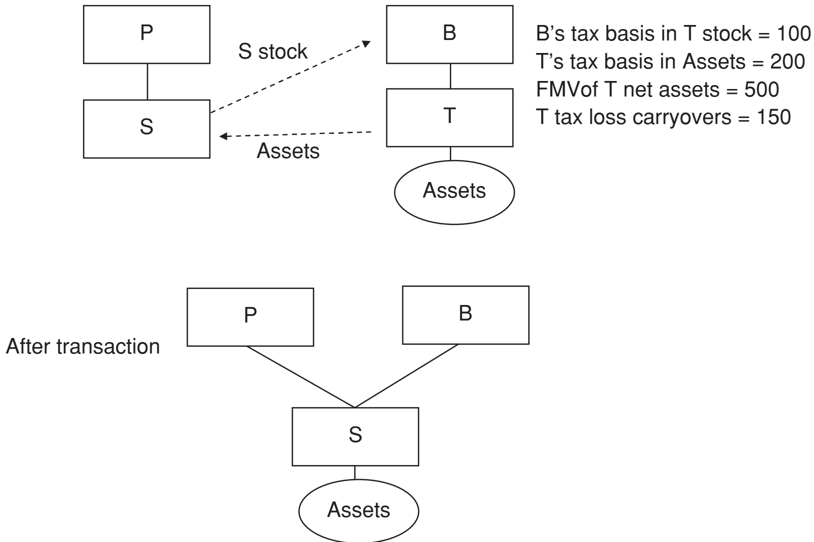


FIGURE 7.5.5–1

The merger of T into S qualifies for special reorganization as T transfers all of its assets and liabilities into S, and S issues stock to T's shareholder B. Neither T nor B recognizes gain or loss on the transfer of assets or receiving S stock. S's tax basis in T assets is RMB200. B's tax basis in S stock is RMB100. S can use T's tax loss carryovers after the merger subject to limitation. Assuming the interest rate on the longest term of treasury bond is 4.5 percent per annum, the annual limitation will be RMB22.5 (RMB500 x 4.5%). S will not be able to use the full amount of T's loss due to short carryover period of five years.

Example 2: Reverse Merger

As illustrated in Figure 7.5.5–2, one possible solution to better utilize T's losses is a reverse merger. Instead of T merging into S, S can be merged into T, with T as the surviving entity. Specifically, S would transfer all of its assets and liabilities to T, and T would issue T stock to P.

As T is not the merged entity, post-merger T (including all assets of S) can continue to use T's pre-merger tax losses to offset T's post-merger income without limitation. T probably can change its name to S after the merger if the S brand is important.

[66] Article 26 of SAT Gong Gao 2010 No. 4.

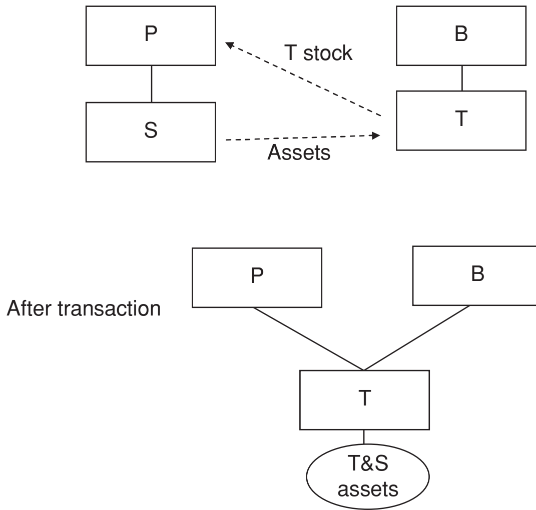


FIGURE 7.5.5–2

Example 3: Newly Established Merger

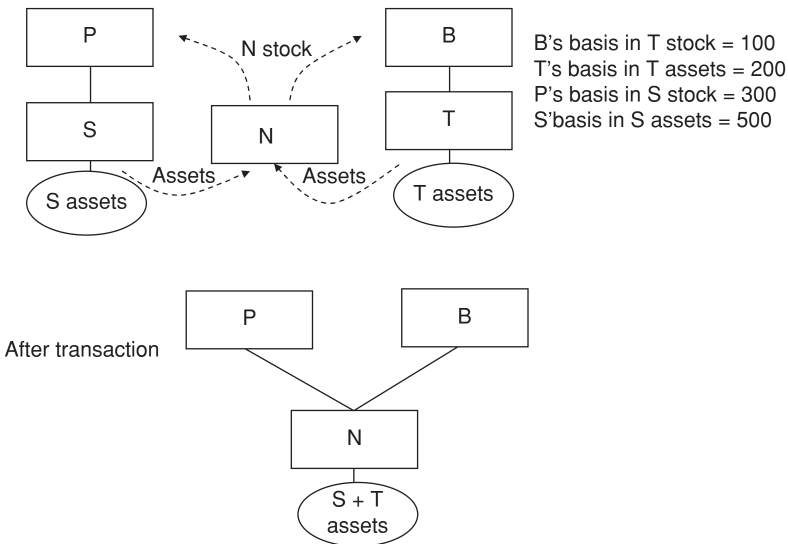


FIGURE 7.5.5–3

S and T form a new company N. S and T transfer all of their respective assets and liabilities to N in exchange for N stock. This is a newly established merger which is qualified for a special reorganization. S and T will not recognize gain or loss on the transfer of assets to N. P and B will not recognize income on receiving N stock. N's tax basis in T assets and S assets are RMB200 and RMB500, respectively. P's tax basis in N stock is RMB300. B's tax basis in N stock is RMB100.

Example 4: Merger without Issuing Stock

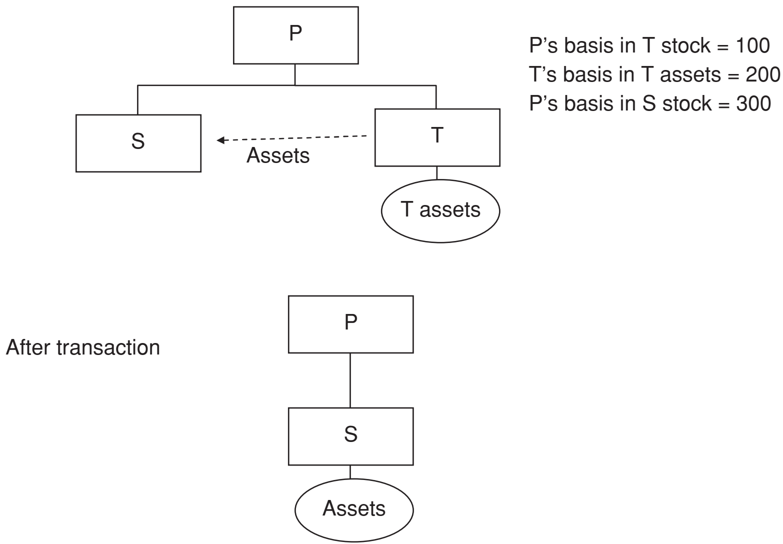


FIGURE 7.5.5–4

T transfers all of its assets and liabilities to S. S does not issue stock to P because P controls S. No gain or loss will be recognized by P and S. P's tax basis in S will be increased by RMB100; P's total tax basis in S immediately after the merger will be RMB400. S's tax basis in T assets will be RMB200.

Example 5: Cash out Minority Interest

The special reorganization rule allows a maximum 15 percent of total consideration to be paid in properties other than the stock of acquiring company or its subsidiaries. Thus the shareholders of a merged company can receive some cash. The rule does not require that cash be paid to all shareholders of a merged company in proportion to their ownership. Accordingly, some minority interests, such as dissenting shareholders, can be cashed out.

T transfers all of its assets and liabilities to S. S issues S stock to C and pays RMB50 in cash to D. Neither T nor C recognizes gain or loss on the transfer of assets or receiving S stock. S's tax basis in T assets is RMB200. C's tax basis in S stock is RMB90. D should recognize RMB40 (RMB50 cash – RMB10 basis) of gain on transfer of T stock. After the reorganization, D will not be a shareholder of S. This example is illustrated in Figure 7.5.5–5.

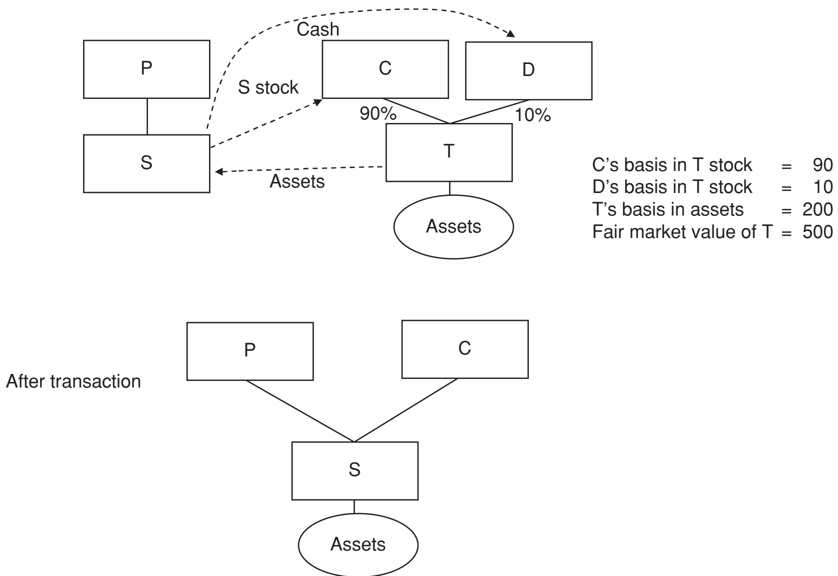


FIGURE 7.5.5–5

7.5.6 DE-MERGER

In a de-merger, one enterprise (the de-merged enterprise) transfers all or a portion of its assets to one or more existing or newly established enterprises (the spin-off enterprises). If a merger satisfies all of the general requirements for a special recognition and at the same time (1) all shareholders of the de-merged enterprise receive stocks of the spin-off enterprises in proportion to their original ownership in the de-merged enterprise; (2) the de-merged enterprise and the spin-off enterprises do not substantially change their respective business operations; and (3) the stock of the spin-off enterprises received by the shareholders of the de-merged enterprise is no less than 85 percent of the total consideration, then the parties can elect to treat the de-merger as a special reorganization.[67] In such a case, the de-merged enterprise will not recognize gain or loss on the transfer of assets to spin-off enterprises; the shareholders of de-merged enterprise will not recognize income for receiving stocks of spin-off enterprises; and the spin-off enterprises will not recognize income on receiving assets from the de-merged enterprise.[68] The tax basis of the spin-off enterprises in the assets and liabilities received from the de-merged enterprise shall be determined according to the original tax basis of the de-merged enterprise in those assets and liabilities.[69] The spin-off enterprises assume the tax attributes in relation

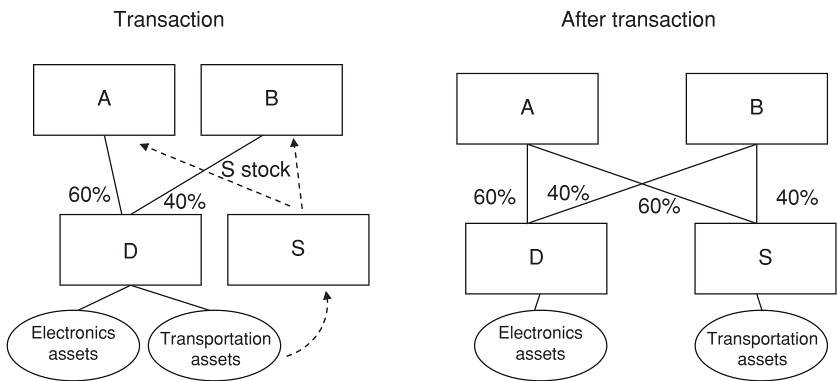
[67] Article 6(5) of Cai Shui [2009] No. 59.

[68] Article 6(6) of Cai Shui [2009] No. 59.

[69] Article 6(5)(1) of Cai Shui [2009] No. 59.

to the assets received.[70] If the de-merged enterprise has an unexpired tax-loss carryover immediately before the de-merger, a portion of the loss carryover can be allocated to the spin-off enterprises. Such allocation is based on the percentage of total pre-de-merge assets received by the spin-off enterprises.[71] The tax basis of shareholders of the de-merged enterprise in the stock of a spin-off enterprise (the new shares) depends on whether the shareholders need to surrender all or a portion of their stock in the de-merged enterprise (the old shares). If the shareholders surrender their old shares in exchange for new shares, their tax basis in the new shares shall be determined according to their basis in the old shares surrendered. If the shareholders do not need to surrender the old shares, they can elect either (1) to have a zero basis in the new shares; or (2) to allocate their original basis in the old shares between the old shares and the new shares according to the percentage of total pre-transaction net assets that each enterprise owns immediately after the transaction.[72]

Example 1



D before de-merger

	Electronics	Transportation	Total
Net book value/tax basis	200	100	300
Market value of net assets	400	300	700
Net operating losses			90
A's tax basis in D stock			60
B' tax bas is in Dstock			40

FIGURE 7.5.6–1

[70] Article 6(5)(2) of Cai Shui [2009] No. 59.

[71] Article 6(5)(3) of Cai Shui [2009] No. 59.

[72] Article 6(5)(4) of Cai Shui [2009] No. 59.

D has two lines of business, electronics and transportation. D transfers the assets and liabilities in the transportation business to a newly established company S; S issues stock to the shareholders of D, A, and B, in proportion of their ownership in D. After the transaction, D and S continue to operate the electronics business and transportation business, respectively. The parties elect to treat the de-merger as a special reorganization.

No gain or loss will be recognized by the parties (A, B, D, and S) on the de-merger transaction. S's tax basis in the transportation business is RMB100. The pre-de-merger loss carryover is allocated to D and S as follows:

$$\text{To D} = 90 \times 200 \div 300 = \text{RMB60}$$

$$\text{To S} = 90 \times 100 \div 300 = \text{RMB30}$$

Assuming A and B are not required to surrender shares of D in the transaction, they can elect a zero basis in their stock of S. Alternatively, they can allocate part of their basis from D stock to S stock based on net assets of D and S immediately after the de-merger. Such basis allocation is shown below:

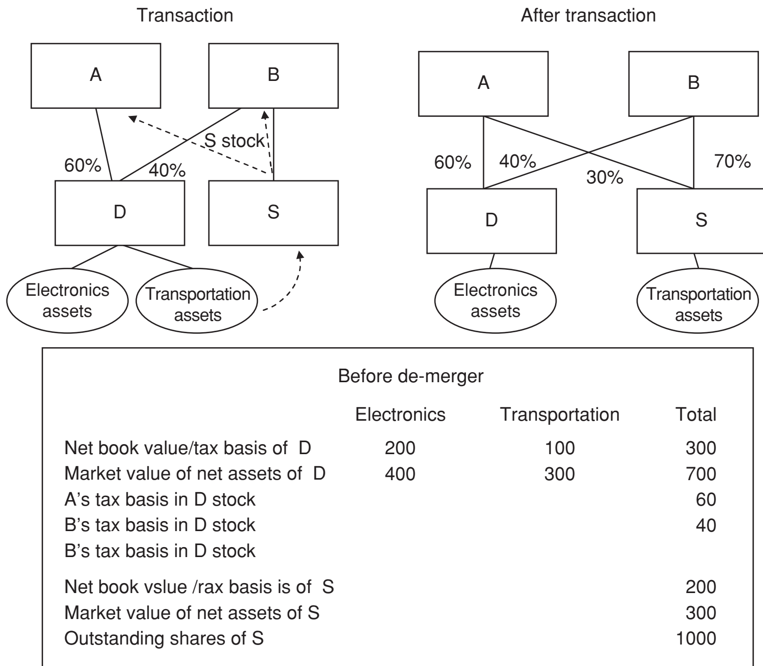
Shareholder	Pre-de-merger D	Post-de-merger D	Post-de-merger S
A	60	40	20
B	40	26.67	13.33

One important feature for a de-merger qualifying special reorganization is that all the shareholders of a de-merged company must receive stock of spin-off enterprises. As such, minority interest cannot be cashed out in spin-off enterprises; if cash is distributed as part of de-merger, it should be distributed to all shareholders of de-merged enterprises in proportion to their ownerships in the enterprise.

A de-merger does allow the de-merged enterprise to transfer assets to an existing enterprise. It is not clear whether the existing enterprise can be an existing operating company. China corporate law and practice generally do not allow people to set up shelf companies. If the existing enterprise can be an existing operating company, there may be an issue on ownership of "spin-off" enterprise for special organization qualification purpose. The following example illustrates this issue.

Example 2

As illustrated in Figure 7.5.6–2, S is a company in the transportation business and was 100 percent owned by B before the reorganization. D transfers all of its assets and liabilities in the transportation business to S. S issues 600 shares to A and 400 shares to B. Although A and B receive stock of S in proportion to their respective original ownership in D, the respective ownership of A and B in S is not identical to their respective



Before de-merger

	Electronics	Transportation	Total
Net book value/tax basis of D	200	100	300
Market value of net assets of D	400	300	700
A's tax basis in D stock			60
B's tax basis in D stock			40
B's tax basis in D stock			
Net book vslue /rax basis is of S			200
Market value of net assets of S			300
Outstanding shares of S			1000

FIGURE 7.5.6–2

ownership in D because of B pre-de-merger ownership in S. As a result, after the reorganization, A and B own 30 percent and 70 percent of S, respectively.

The special reorganization rule concerning de-mergers requires that A and B "obtain" equity of S in proportion to their original ownership percentage in D; the rule does not say the ownership of A and B in S must be identical to that in D. However, if a transaction like Example 2 can be qualified as a special reorganization, people can easily avoid the 75 percent asset requirement in a stock for asset acquisition by re-characterizing an asset acquisition as a de-merger. Accordingly, it is most likely that the transaction will not be qualified as a special reorganization.

7.5.7 CONSIDERATION OTHER THAN QUALIFIED STOCK

In special reorganizations involving stock acquisition, asset acquisition, mergers, and de-mergers, 15 percent or less of the total consideration can be paid in properties other than qualified stock. Such non-equity considerations include cash, bank deposits, receivables, securities other than the acquiring enterprise stock or its controlled entity's stock, inventories, fixed assets, other assets, and the assumption of liabilities.[73] These non-equity considerations are commonly called "boot." Gain or loss on the transfer of asset or stock

[73] Article 2 of Cai Shui [2009] No. 59.

should be recognized with respect to the boot. The gain or loss should be calculated using the following formula:

Gain or loss on asset transfer
= (Fair market value of the transferred assets
– Tax basis in the transferred assets)
× (Boot ÷ Fair market value of the transferred assets)

Because of the gain or loss recognition with respect to boot, the relevant tax basis in the assets transferred should be adjusted accordingly.[74] However, the special reorganization tax rule does not address how the tax basis will be adjusted. The following examples illustrate the application of gain or loss recognition formula to some special reorganizations. We will also discuss the tax basis adjustment based on the author's understanding of general principles of the CIT Law, which may not necessarily be the same as the interpretations of tax authorities in practice or any written clarification that may be issued by the MOF and/or the SAT in the future.

Example 1: Stock Acquisition

A owns 100 percent of a limited liability company X. A's tax basis in X is RMB100. P is a listed company. In a special reorganization, A transfers 90 percent of all outstanding shares of X to P in exchange for 200 shares of P and cash in amount of RMB30. At the time of the transaction, the market value of P stock is RMB1.2 per shares. Applying the formula,

A's gain on equity transfer = [(RMB1.2 x 200 shares + RMB30) – RMB90] x [RMB30÷(RMB1.2 x 200 shares + RMB30)] = RMB20

The full RMB20 is treated as gain on property transfer according to the special reorganization rule. A's tax basis in X stock transferred to P is RMB90 (RMB100 x 90%). A should have a carryover basis in his shares of P received. Because of gain recognition for boot, A's tax basis should be increased by RMB20. However, because A received RMB30, his basis should be decreased by RMB30. Accordingly, A's tax basis in 200 shares of P stock immediately after the reorganization should be RMB80 (RMB90 + RMB20 – RMB30). The tax rule does not give us this direct answer to basis adjustment. We know that the total consideration that A receives is RMB270 (P shares plus cash) and his tax basis in X stock transferred is RMB90. The total gain realized by A on the transaction is RMB180 (RMB270 – RMB90). A recognizes RMB20 of gain on the transaction; the deferred gain should be RMB160. The fair market value of 200 shares of P stock is RMB240. The adjusted

[74] Article 6(6) of Cai Shui [2009] No. 59.

tax basis of RMB80 would give us a correct economic answer (i.e., RMB240 – RMB80 = RMB160). P's tax basis in X stock should be RMB110, that is, A's tax basis in the stock immediately before the acquisition (RMB90) increased by the gain recognized by A (RMB20). We can use the same logic as for A to test P's tax basis adjustment. As A's deferred gain is RMB160, P would have recognized the same amount gain if P were to sell the stock immediately after the reorganization; RMB110 of tax basis of P in X stock will give us an economically correct answer (i.e., FMV of X stock RMB270 – RMB110 = RMB160). The tax basis adjustment for A does not affect the tax basis of X in its assets.

Example 2: Asset Acquisition

B owns 100 percent of a limited liability company Y. B's tax basis in Y is RMB100. Y's tax basis in its assets is RMB300. P is a listed company. In a special reorganization, Y transfers 80 percent of its total assets to P in exchange for 200 shares of P and marketable securities with a fair market value of RMB90. Immediately before the transaction, the market value of P stock is RMB3.15 per shares and Y's tax basis in the assets transferred to P is RMB240. Applying the formula,

Y's gain on asset transfer = [(RMB3.15 x 200 shares + RMB90) – RMB240] x [RMB90÷(RMB3.15 x 200 shares + RMB90)] = RMB60

The full RMB60 is treated as gain on property transfer according to the special reorganization rule. Based on the same logic as discussed in Example 1, Y's tax basis in 200 P shares should be RMB210, that is, its tax basis in the assets transferred (RMB240), increased by the gain recognized (RMB60) and decreased by the fair market value of marketable securities received (RMB90). Y's tax basis in the marketable securities received should be RMB90. P's tax basis in the assets received from Y should be RMB300, that is, Y's tax basis in the assets immediately before the reorganization (RMB240), increased by the amount of gain recognized by Y (RMB60). B's basis in Y will remain unchanged.

Example 3: Merger

C owns 100 percent of a limited liability company Z. C's tax basis in Z is RMB100. Z's tax basis in its assets is RMB300. P is a listed company. In a special reorganization, Z transfers all of its total assets and liabilities to P; P issues 200 shares of P to C and pays C cash in the amount of RMB50. Immediately before the transaction, the market value of P stock is RMB2.25 per shares. Applying the formula,

C's gain on asset transfer = [(RMB2.25 x 200 shares + RMB50)–RMB100] x [RMB50÷(RMB2.25 x 200 shares + RMB50)] = RMB40

The full RMB40 is treated as gain on property transfer according to the special reorganization rule. Based on the same logic as discussed in Example 1, C's tax basis in 200 P shares should be RMB90, that is, its tax basis in the equity in Z (RMB100), increased by the gain recognized (RMB40), decreased by the cash received

(RMB50). P's tax basis in the assets received from Y should be RMB300, which is Y's tax basis in the assets immediately before the reorganization.

Why is P's tax basis in the assets not adjusted? P carries over Z's basis. In spite of boot to C, Z does not recognize any gain in the merger; therefore, P's tax basis in the assets transferred from Z should not be adjusted. This tax treatment is consistent with the general tax principle of deferral in special reorganization. The special organization should merely defer gain or loss recognition, rather than changing the amount of gain or loss. Suppose in the facts of Example 3 that the parties elect to treat the merger as an ordinary reorganization. Z would be treated as receiving 200 shares of P stock with fair market value of RMB450 and RMB50 cash and then distributing P stock and cash to C in a deemed liquidation. In such taxable transaction, Z would recognize a gain of RMB200 (FMV of assets RMB500 – tax basis RMB300); C would have RMB400 (RMB500 proceeds – RMB100 tax basis) of income (dividends and gain). The distribution should be less than RMB500 because of CIT paid by Z; for illustration purposes, such CIT is disregarded. Now, the parties elect to treat the merger as a special reorganization. As discussed, C recognizes RMB40 gain on boot payment and his tax basis in P stock is RMB90. If C disposes of his shares of P stock, C would have RMB360 (FMV of P shares RMB450 – RMB90 basis) of gain. As such the sum of RMB40 of gain recognized in the current period and RMB360 of gain deferred is a total gain of RMB400, same as the total amount income recognized by C in an ordinary reorganization. If P disposes of its shares of Z stock at fair market value of RMB500, P would recognize RMB200 (RMB500 – RMB300 tax basis) of gain, same amount of gain that would be recognized by Z in an ordinary reorganization.

Example 5: Merger with Cashing out Minority Interest

E and F own 90 percent and 10 percent of Q, a limited liability company, respectively. The tax basis of E and F in equity of Q is RMB90 and RMB10, respectively. Q has a tax basis of RMB300 in its assets with a fair market value of RMB500. In a special reorganization, Q transfers all of its assets and liabilities to S, a limited liability company; S issues 180 shares of S stock with a fair market value of RMB450 to E and distributes RMB50 cash to F. Applying the formula,

F's gain on asset transfer = (RMB50–RMB10) x (RMB50÷RMB50) = RMB40

E does not recognize a gin or loss as E has not received a boot. E's tax basis in S shares is RMB90. S's tax basis in the assets received from Q is RMB300.

Example 6: De-merger

A and B own 60 percent and 40 percent of D, a limited liability company, respectively. The tax basis of A and B in equity of D is RMB60 and RMB40, respectively. D has two lines of business, electronics and transportation. D has a tax basis (and net asset) of RMB200 in its assets in electronics business with a fair market value

of RMB400 and a tax basis (and net asset) of RMB200 in its assets in transportation business with a fair market value of RMB300. In a special reorganization, D transfers its assets and liabilities in transportation business to S, a newly established limited liability company; S issues 60 percent and 40 percent of S stock to A and B respectively. The fair market value of S stock issued to A and B is RMB270. A receives RMB18 cash and B receives RMB12 cash in the reorganization. A and B elect to allocate their old basis in pre-de-merger D between post-de-merger D and S. Such basis allocation (before adjustment for boot) is shown below:

Shareholder	Pre-de-merger D	Post-de-merger D	Post-de-merger S
A	60	30	30
B	40	20	20

Applying the formula,

$$\text{A's gain on asset transfer} = (\text{RMB}300 \times 60\% - \text{RMB}30) \times (\text{RMB}18 \div \text{RMB}300 \times 60\%) = \text{RMB}15$$

$$\text{B's gain on asset transfer} = (\text{RMB}300 \times 40\% - \text{RMB}20) \times (\text{RMB}12 \div \text{RMB}300 \times 40\%) = \text{RMB}10$$

The special reorganization rule only provides for "gain or loss on transfer of asset corresponding to boot received."[75] Accordingly, the income of A and B due to receiving boot appears to be treated as gain on transfer of property rather than dividends even if D has sufficient earnings and profits. After considering the boot received, A's tax basis in S should be RMB27, that is, its tax basis before adjustment 30, increased by the gain recognized (RMB15), and decreased by the cash received (RMB18). B's tax basis in S should be RMB18, that is, its tax basis before adjustment 20, increased by the gain recognized (RMB10), and decreased by the cash received (RMB12).

7.5.8 CROSS-BORDER REORGANIZATION

The acquisition of stock or assets between China and an overseas destination (including Hong Kong, Macao, and Taiwan) will generally not qualify as a special reorganization unless the transaction satisfies all of the general requirements for special reorganizations as discussed in Chapter 7.5.1 and is one of three types of transactions prescribed in the special reorganization tax rule concerning cross-border transactions.

[75] Article 6(6) of Cai Shui [2009] No. 59.

7.5.8.1 Transfer of Equity of Resident Enterprise by One Non-Resident Enterprise to Another Non-Resident Enterprise

Special reorganization tax treatment can be elected for a transfer of equity of a resident enterprise by one non-resident enterprise to another non-resident enterprise if the following conditions are met:[76]

(1) The non-resident enterprise transferor must directly own 100 percent of equity of the non-resident enterprise transferee;
(2) The transfer must not result in a change of withholding tax in a subsequent transfer of the equity; and
(3) The transferor must promise in writing to the tax authority in charge that it will not transfer the shares of the non-resident enterprise within three years after the reorganization.

Under the merger and acquisition tax rule effective prior to January 1, 2008, a foreign enterprise can transfer its equity interest in an enterprise in China to another enterprise, including foreign enterprise or China investment holding company, at cost and therefore does not recognize gain or loss if (1) the transferor directly or indirectly owns 100 percent of the transferee, (2) the transferee directly or indirectly owns 100 percent of the transferor, or (3) a common parent directly or indirectly owns 100 percent of both the transferor and the transferee.[77] The old rule could be used to avoid China tax on disposal of equity investment in some China invested enterprises. Suppose Foreign Company A owns 100 percent equity of a Chinese company C. If A disposes of C, A would be subject to China income tax on the gain on disposal. A could set up a 100 percent owned subsidiary B in desirable jurisdiction. A could transfer equity of C to B under the old tax deferral rule. Subsequently, A could sell shares of B to an unrelated foreign company without paying any China tax. The requirements for special reorganization for foreign to foreign equity transfer will prevent foreign enterprises from entering into this type of transaction without recognizing CIT on the transaction.

The requirement of 100 percent direct ownership of the transferor in the transferee makes many bona fide enterprise reorganizations taxable. Suppose that a non-resident enterprise P owns 100 percent of a non-resident holding company S; S owns 100 percent of China resident enterprise C. For valid business purposes, S distributes the equity of C to P by dividends, liquidation, or upstream merger. Because S does not directly own 100 percent P, the distribution of equity of C to P will be taxable unless otherwise

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[76] Article 7(1) of Cai Shui [2009] No. 59.

[77] The Notice on the Income Tax Treatment Issue Concerning the Equity Transfer for Foreign Enterprises and Foreign Invested Enterprises, Guo Shui Han [1997] No. 207, issued by the SAT on April 17, 1997 and effective till December 31, 2008.

approved by the SAT. Another example is a merger of foreign sister companies. Suppose a non-resident enterprise P owns 100 percent of two non-resident subsidiaries S1 and S2; S1 and S2 own 100 percent of C1 and C2, respectively. C1 and C2 are China resident enterprises. For valid business reasons, S2 is merged into S1. As a result, S2 will need to transfer its equity in C2 to S1. The transfer of C2 to S1 is taxable because S2 (the transferor) does not own 100 percent of S1 (the transferee). From a tax policy perspective, there is no reason to make these two transactions taxable, as the transaction is not intended for, and generally will not result in, reduction of tax.

7.5.8.2 Transfer of Equity of Resident Enterprise by One Non-resident Enterprise to Another Resident Enterprise

A non-resident enterprise can transfer its equity interest in a resident enterprise to another resident enterprise in a special reorganization provided the non-resident enterprise directly owns 100 percent equity of the transferee enterprise.[78] The main purpose of this special reorganization rule is to facilitate China foreign invested holding company structure. In such structure, a foreign company sets up a holding company under Chinese laws and transfers equity interests of some or all of its Chinese operating companies to the China holding company. The 100 percent direct ownership requirement, however, will disqualify certain transfers as a special reorganization. Figure 7.5.8–1 below illustrates this point:

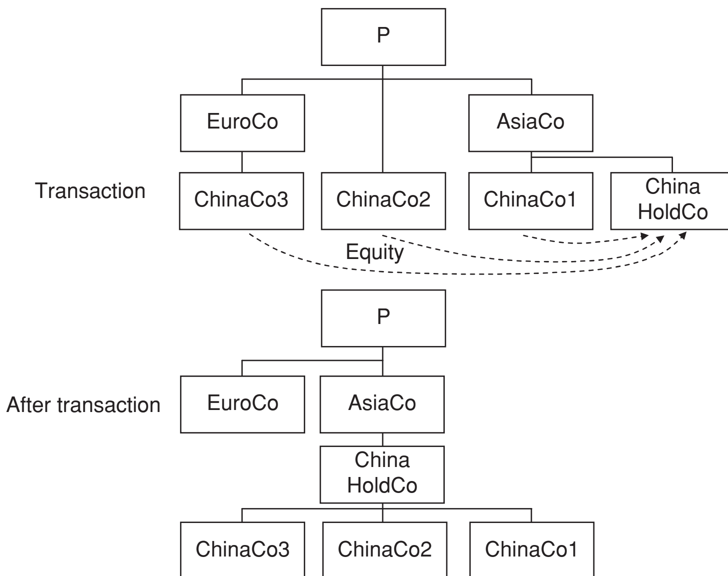

FIGURE 7.5.8–1

[78] Article 7(2) of Cai Shui [2009] No. 59.

P, EuroCo, and AsiaCo are non-resident enterprises. Each of them directly owns an operating subsidiary in China. AsiaCo sets up China HoldCo and transfers ChinaCo1 into China HoldCo in exchange of equity of China HoldCo. P and EuroCo transfer their equity interests in ChinaCo2 and ChinaCo3 to China HoldCo, respectively. After the transactions, P owns AsiaCo; AsiaCo owns China HoldCo, which owns ChinaCo1, ChinaCo2, and ChinaCo3.

The transfer of equity interest in ChinaCo1 by AsiaCo to China HoldCo is qualified as a special reorganization because AsiaCo directly owns 100 percent of China HoldCo. The transfer of equity interest in ChinaCo2 by P to China HoldCo will not be qualified as a special reorganization because P does not directly own China HoldCo. Similarly, the transfer of equity interest in ChinaCo3 by EuroCo to China HoldCo is not qualified as special reorganization either. Accordingly, P and EuroCo should recognize gain on loss on the transfers of ChinaCo2 and ChinaCo3 based on the fair market value of ChinaCo2 and ChinaCo3. From tax policy perspective, it is not clear why the rule allows a tax deferral on the transfer of ChinaCo1, but disallows the tax deferral on the transfer of ChinaCo2 and ChinaCo3. The transfer of equity holding from a non-resident enterprise to a resident enterprise will not avoid or reduce China tax and actually will bring interest to the closer watch of China tax authorities. In our example, if EuroCo disposes of ChinaCo3, EuroCo will be subject to a 10 percent CIT on gain derived from the disposition. After ChinaCo3 is transferred to China HoldCo, if China HoldCo disposes of ChinaCo3, applicable CIT rate on the gain generally will be 25 percent. Furthermore, P could dispose of ChinaCo3 by disposing of EuroCo with a possibility of not paying China tax. The transfer of ChinaCo3 to China HoldCo will eliminate such option of indirectly disposing of a single China operating entity without paying China tax. Accordingly, the tax rule should not discourage this type of transfer into China. Taxpayers may seek special approval from the tax authorities for a special reorganization treatment in transactions like the example. However, only the SAT and the MOF have the authority to approve the satiations that do not meet the special reorganization forms prescribed in the merger and acquisition tax circular. Please see discussions in Chapter 7.4.8.4.

7.5.8.3 Outbound Transfer

A resident enterprise can transfer assets or stock to a 100 percent directly owned non-resident enterprise as an investment. Such transfer is qualified as a special reorganization.[79] However, unlike the no-gain recognition treatment in other types of special reorganization, the transfer in the outbound transaction must recognize gain on the transfer evenly over a ten-year period.[80]

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[79] Article 7(3) of Cai Shui [2009] No. 59.

[80] Article 8 of Cai Shui [2009] No. 59.

This rule will allow a resident enterprise to transfer its equity interest in domestic or foreign company to a first tier wholly-owned foreign subsidiary in a special reorganization as illustrated in Figure 7.5.8–2 below.

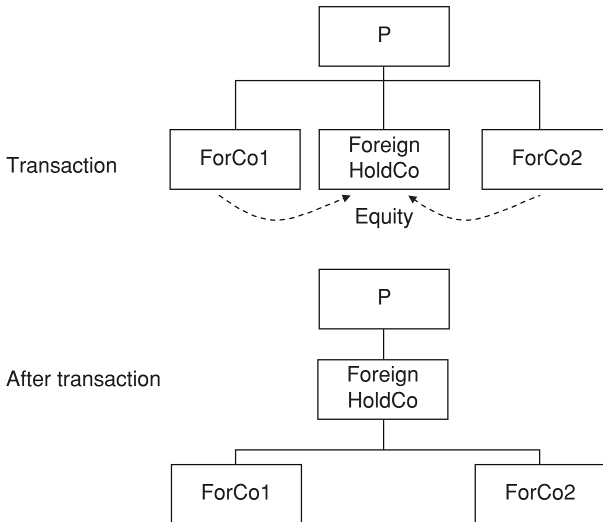

FIGURE 7.5.8–2

P, a resident enterprise, owns two operating subsidiaries, ForCo1 and ForCo2, in a foreign country. P forms a new non-resident holding company, Foreign HoldCo, and then transfers ForCo1 and ForCo2 to Foreign HoldCo. As P directly owns 100 percent of Foreign HoldCo, P can elect to treat the transfer as a special reorganization and recognize gain realized on the transfer (i.e., the fair market value of ForCo1 and ForCo2 in excess of P's tax basis in the equity of ForCo1 and ForCo2) over a ten-year period.

In some situations, a resident enterprise may want to invest some assets into an indirect subsidiary. Suppose in the above example, P sets up two tiers of holding company and transfers foreign operating companies to the second tier holding company as illustrated in Figure 7.5.8–3 below.

P transfers equity of ForCo1 and ForCo2 to Regional HoldCo, which should qualify for a special reorganization because P directly owns 100 percent of Regional HoldCo. Regional HoldCo subsequently transfers the equity of ForCo1 and ForCo2 to Country HoldCo. One of the general requirements for all types of special reorganization is that "the original shareholders who receive payment in equity in enterprise reorganization cannot transfer the equity within 12 months after the reorganization." It is not clear whether this requirement will prevent Regional HoldCo from transferring the equity of ForCo1 and ForCo2 to Country HoldCo within 12 months of the transfer of equity from P. Technically, Regional HoldCo is not an original shareholder who receives payment in equity; it is the party that receives investment contribution. As such, literally reading the circular would lead to a conclusion that the subsequent transfer of ForCo1 and ForCo2

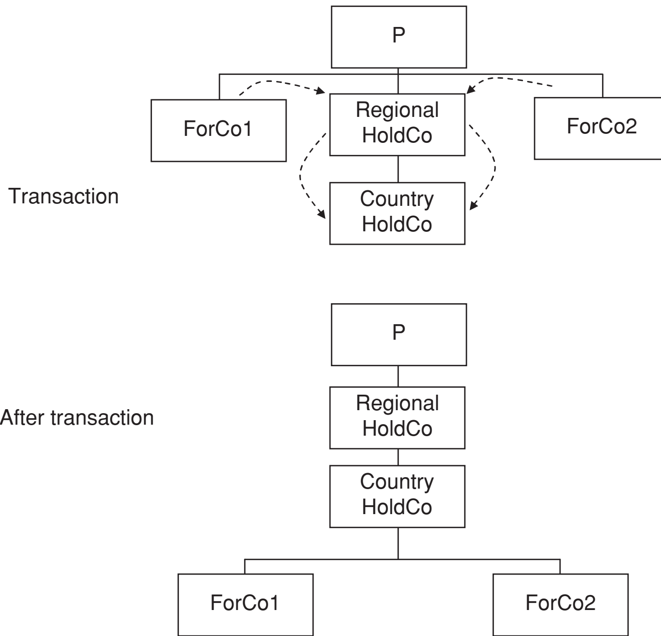

FIGURE 7.5.8–3

by Regional HoldCo to Country HoldCo should not disqualify the special reorganization treatment of the first transfer; the second transfer itself is not taxable assuming Regional HoldCo is not a resident enterprise. Such a conclusion would provide an opportunity to defer tax on exit from a foreign investment. In our example, suppose after the first transfer (P transfers ForCo1 and ForCo2 to Regional HoldCo), Regional HoldCo sells shares of ForCo1 to an unrelated party. Regional HoldCo generally will not be subject to China tax until distributing profits to P. Of course, P may be required to recognize a deemed dividend according to CFC rule. However, CFC rule may be avoided by Regional HoldCo investing cash into other operations (e.g., commercial reasons for not repatriating cash). The tax authorities may crack down on this two-step transfer without business reasons by applying general anti-avoidance rule.

7.5.8.4 Other Situations

The merger and acquisition tax circular has left some room for other types of cross-border transactions that can be qualified as a special reorganization. This can be any situation that is approved by the MOF and the SAT.[81] Accordingly, if a transaction is not covered by the special reorganization rule, the taxpayer may apply for a special approval of the tax authorities level by level. However, only the MOF and the SAT have final approval

[81] Article 7(4) of Cai Shui [2009] No. 59.

authority. Because of the requirement of 100 percent direct ownership of the transferor in the transferee (see discussions in Chapter 7.5.8.1 and 7.5.8.2), many bona fide enterprise reorganizations would not be qualified for special reorganization. The tax authorities at the local level may request for approval of the SAT for special situations on behalf of taxpayers. It is unlikely that the SAT will reply all of such requests. It is possible that the SAT may issue interpretation circular to authorize special reorganizations with some deviation from those described in Cai Shui [2009] No. 59 replying to some of the requests. So far, no such circular has been issued. The SAT might be reluctant to broaden the scope of special reorganization without the consent of the MOF as Guo Shui Han was jointly issued by both the SAT and the MOF.

7.5.9 STEP TRANSACTIONS

The merger and acquisition tax circular states the principle of "substance over form." If stock or assets were transferred in several steps before or after reorganization within a 12-month period, those transactions will be treated as a single reorganization transaction.[82] This step-transaction doctrine permits a series of formally separate steps to be amalgamated and treated as a single transaction if the steps in substance are integrated to achieve the same result as a single transaction. The tax rule has not provided detailed explanation of the doctrine other than the specified time period. This rule can be a powerful weapon for the tax authorities to deny special reorganization tax treatment of a transaction by considering other transactions as part of an integrated reorganization.

On the other hand, the step transaction rule seems to allow a taxpayer to treat a series of transactions as a single reorganization for the purpose of electing special reorganization treatment. Suppose Company A acquires 30 percent of stock of Company B by issuing A's stock to Company C, the only shareholder of B. Eight months later, A acquires additional 50 percent of B's outstanding shares by issuing A's stock to C. Separately, neither of the transactions is qualified as a special reorganization because each transfer is less than 75 percent of equity of B. If we treat both as a single reorganization, A would acquire 80 percent of total equity of B. As such, the parties can elect to treat the transaction as a special reorganization assuming all of other conditions for special reorganization are met. Suppose the first acquisition takes place on November 1, Year 1 and the second transaction on July 1, Year 2. On or before May 30, Year 2, C needs to file its annual CIT return for Year 1. If it is expected that the reorganization will qualify for a special reorganization when all steps completed and if all the parties to the transaction agree on the special reorganization treatment, the parties can take a position to treat the first step of the transaction as a special reorganization. After the satisfaction in review the qualification of materials submitted, the tax authority may temporarily apply the special reorganization

[82] Article 10 of Cai Shui [2009] No. 59.

treatment for Year 1. The tax authority will confirm the special reorganization tax treatment after the completion of step two and review the filings for Year 2.[83] However, if it cannot be predicted whether the whole reorganization can satisfy the requirements of special reorganization (e.g., not sure whether 75 percent or more stock can be acquired within 12 months), the ordinary reorganization treatment should apply. If the whole reorganization qualifies for special reorganization after completed, the enterprise may adjust its return for Year 1 and apply for a tax refund or credit the overpayment for Year 1 to the following Years.[84]

7.5.10 FILING REQUIREMENT

If a transaction satisfies the requirements for a special reorganization and the parties elect special reorganization tax treatments, the parties must file documentation to prove that the transaction meets the requirements. The documentation must be filed at the time of filing of the annual income tax return for the year in which the reorganization is completed. Failure to file required information by enterprises on or before the deadline, the transaction cannot be treated as a special reorganization.[85] The SAT provided guidance to specific filing requirements for each type of special reorganization. If the parties need a confirmation of the tax authorities on the special reorganization treatment, the parties may have the lead party file an application for the confirmation with the tax bureau in charge; the tax bureau should forward the application to the provincial level of tax bureau for the confirmation. If the lead party and other parties are not in the same province, municipality, or autonomous region, the provincial tax authority in charge of the lead party should copy the application materials to the relevant tax authorities in the other province, municipality, or autonomous region.[86] The lead party in a special reorganization is the debtor in a debt restructuring, the transferor in a share or asset acquisition, the surviving enterprise in a merger by absorption, the enterprise that owned majority assets in a merger where the surviving company is a newly established enterprise, or the de-merged or spin-off enterprise in a de-merger.[87]

7.5.10.1 Debt Restructuring

In a debt restructuring, if the debtor enterprise elects to recognize gain on debt settlement over a five-year period because the taxable income derived from the debt restructuring is

[83] Article 32 of SAT Gong Gao 2010 No. 4.
[84] Article 33 of SAT Gong Gao 2010 No. 4.
[85] Article 11 of Cai Shui [2009] No. 59.
[86] Article 16 of SAT Gong Gao 2010 No. 4.
[87] Article 17 of SAT Gong Gao 2010 No. 4.

greater than 50 percent of current year taxable income, the enterprise should prepare the following documents.[88]

(1) Overall description of debt restructuring including explanation of business purpose of the debt restructuring;
(2) The debt restructuring agreement signed by all parties;
(3) The taxable income realized in the debt restructuring and the current year taxable income of the debtor enterprise; and
(4) Other information that may be required by the tax bureau in charge.

If a debt restructuring is a conversion of debt into equity and therefore the debtor temporarily does not recognize income, the enterprise should prepare the following documents.[89]

(1) Overall description of debt restructuring including explanation of business purpose of the debt restructuring;
(2) The agreement on debt to equity conversion signed by all parties;
(3) The evidence of fair market value of stock converted from debt;
(4) The documents evidencing the change of equity confirmed by administration for industry and commerce or other relevant government office; and
(5) Other information that may be required by the tax bureau in charge.

7.5.10.2 Stock Acquisition

In a stock acquisition, enterprises should prepare the following documents.[90]

(1) Overall description of the stock acquisition including explanation of business purpose of the transaction;
(2) The share purchase agreement signed by both parties;
(3) The appraisal report of fair market value of stock transferred issued by a PRC licensed appraiser;
(4) The documents evidencing that the transaction satisfies the requirements of special reorganization tax treatment, including the percentage of equity transferred, the consideration paid, and the promise that the business activities with respect to the assets involved in a reorganization will not substantially change and the former major shareholders will not transfer the stock received within 12 months;

[88] Article 22(1) of SAT Gong Gao 2010 No. 4.
[89] Article 22(2) of SAT Gong Gao 2010 No. 4.
[90] Article 23 of SAT Gong Gao 2010 No. 4.

(5) The documents evidencing the change of equity confirmed by administration for industry and commerce or other relevant government office; and
(6) Other information that may be required by the tax bureau in charge.

7.5.10.3 Asset Acquisition

In an asset acquisition, enterprises should prepare the following documents.[91]

(1) Overall description of the asset acquisition including explanation of business purpose of the transaction;
(2) The asset purchase agreement signed by all the parties;
(3) The appraisal report of fair market value of assets transferred issued by a PRC licensed appraiser;
(4) The valid evidence of tax basis of acquiring enterprise in the stock;
(5) The documents evidencing that the transaction satisfies the requirements of special reorganization tax treatment, including the percentage of total asset transferred, the consideration paid, and the promise that the business activities with respect to the assets involved in a reorganization will not substantially change and the former major shareholders will not transfer the stock received within 12 months;
(6) The documents evidencing the change of equity confirmed by administration for industry and commerce or other relevant government office; and
(7) Other information that may be required by the tax bureau in charge.

7.5.10.4 Merger

In a merger, the enterprises should prepare the following documents:[92]

(1) Overall description of the merger including explanation of business purpose of the transaction;
(2) The approval document issued by the relevant government office concerning the merger;
(3) The statement of ownership relationship of the parties to the merger;
(4) The net asset, and each asset and liability of the merged enterprise and their book value and tax basis;
(5) The documents evidencing that the transaction satisfies the requirements of special reorganization tax treatment, including the percentage of stock consideration, and the promise that the business activities with respect to the assets

[91] Article 24 of SAT Gong Gao 2010 No. 4.
[92] Article 25 of SAT Gong Gao 2010 No. 4.

involved in a reorganization will not substantially change and the former major shareholders will not transfer the stock received within 12 months;

(6) The documents evidencing the change of equity confirmed by administration for industry and commerce or other relevant government office; and

(7) Other information that may be required by the tax bureau in charge.

7.5.10.5 De-merger

In a de-merger, the enterprises should prepare the following documents:[93]

(1) Overall description of the de-merger including explanation of business purpose of the transaction;

(2) The approval document issued by the relevant government office concerning the de-merger;

(3) The net asset, and each asset and liability of the de-merged enterprise and their book value and tax basis;

(4) The documents evidencing that the transaction satisfies the requirements of special reorganization tax treatment, including the percentage of stock consideration, and the promise that the business activities with respect to the assets involved in a reorganization will not substantially change and the former major shareholders will not transfer the stock received within 12 months; and

(5) The documents evidencing the change of equity of the de-merged enterprise confirmed by the office administration for industry and commerce;

(6) Copies of business licenses of the de-merged enterprise and the spin-off enterprises after the de-merger;

(7) Copies of accounting treatment of the de-merged and spin-off enterprises; and

(8) Other information that may be required by the tax bureau in charge.

7.5.10.6 Outbound Transaction

In a reorganization where a resident enterprise contributes stock or asset to its 100 percent-owned foreign subsidiary, the enterprise should submit the following documents.[94]

(1) Overall description of the stock acquisition including explanation of business purpose of the transaction;

(2) The share purchase agreement signed by both parties;

(3) The ownership relationship of the parties;

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[93] Article 27 of SAT Gong Gao 2010 No. 4.

[94] Article 37 of SAT Gong Gao 2010 No. 4.

(4) The appraisal report of stock or asset transferred issued by a PRC licensed appraiser. The report should separately list the fair market value of each asset and liability transferred;
(5) The documents evidencing that the transaction satisfies the requirements of special reorganization tax treatment, including the percentage of equity or assets transferred, the consideration paid, and the promise that the business activities with respect to the assets involved in a reorganization will not substantially change and the stock received will not be transferred within 12 months; and
(6) Other information that may be required by the tax bureau in charge.

7.5.10.7 Follow-up Filings

An enterprise in a special reorganization should file a statement with the tax bureau in charge when it files its tax return for the year following the year of reorganization. This statement should demonstrate that the required conditions for the special reorganization did not change within 12 consecutive months after the reorganization.[95] If one party to the reorganization changes its business, the nature of enterprise, or asset or stock structure so that the reorganization no longer qualifies for the requirements of special reorganization, the party should notify such change to all the parties to the reorganization within thirty days of the change; the lead party should notify the tax bureau in charge accordingly. Within sixty days of such change, the parties should make a tax adjustment to the taxable income for the year of reorganization according to the tax treatment for an ordinary reorganization. The parties to the reorganization should recognize gain or loss based on the relevant fair market value and tax basis on the date of completion for the original reorganization; the tax basis of relevant assets and liabilities should also be adjusted accordingly.[96]

7.6 Tax Incentives Existing Prior to Transaction

In an asset acquisition, the acquiring enterprise acquires assets of the acquired enterprise. After the transfer, the acquired enterprise continues to exist. As such, the tax incentives granted to the acquired enterprise will not be transferred to the acquiring enterprise. If the acquired enterprise continues to meet the qualification for the tax incentives, the entity can continue to enjoy the tax incentives. However, the transfer of substantial assets of the acquired enterprise may change the conditions for granting the tax incentives. For example, a reduced tax rate for High and New Technology Enterprise is granted based

[95] Article 29 of SAT Gong Gao 2010 No. 4.

[96] Article 30 of SAT Gong Gao 2010 No. 4.

on specific business, IP rights, R&D capabilities, etc. If an asset acquisition results in the change of those conditions, the transferor/acquired enterprise will no longer be qualified as a High and New Technology Enterprise and therefore will not be eligible for the reduced tax rate.

In a stock acquisition, the transfer of stock of the acquired enterprise merely changes the ownership of the enterprise; the acquired enterprise will continue to operate. If the acquired enterprise does not change its nature of business and operations, it should continue to enjoy tax incentives granted prior to the reorganization.

In a merger by absorption, if there is no change in the nature of the enterprise and the conditions for granting tax incentives, the surviving enterprise can continue to enjoy the pre-merger tax incentives of the surviving enterprise for the remaining incentive period. The tax incentive amount is based on the taxable income of the enterprise for the year prior to the merger; if the enterprise had a loss in that year, the taxable income is considered to be zero.[97] This rule will penalize merger in many situations where one or both enterprises have pre-merger tax incentives.

For example 1: A and B each was granted CIT exemption for 2008 and 2009 and a 12.5 percent CIT rate for 2010, 2011, and 2012. The normal tax rate after tax holiday for them is 25 percent. A was merged into B on July 1, 2009. There is no change of nature of business after the merger. The table below illustrates the tax results with and without merger.

Year	Without merger				With merger			
	A		B		A		B	
	Income	CIT	Income	CIT	Income	CIT	Income	CIT
2008	100	0	100	0	100	0	100	0
2009	200	0	200	0	100	0	300	50
2010	300	37.5	300	37.5			600	137.5

Without merger, A and B would pay no CIT in 2009 and a 12.5 percent CIT on all taxable income in 2010. After the merger, B can continue to enjoy tax incentives. However, B's tax incentive is computed based on the taxable income of B for 2008, the year prior to the merger. As such, the tax exemption will only apply to RMB100 of its total taxable income of RMB300, which includes RMB200 from its original business and RMB100 from A's original business. Similarly, for 2010, a reduced CIT rate of 12.5 percent would only apply to RMB100 of B's total taxable income; the remaining RMB500 of taxable income would be subject to 25 percent CIT rate.

[97] Article 9 of Cai Shui [2009] No. 59.

Example 2. The facts are the same as Example 1 except that A and B are merged into a newly established enterprise C. The special reorganization rule does not address the treatment of tax incentives in a newly established merger. Applying the principle and logic contained in the provision applicable to absorption merger, C probably would not be entitled to any tax incentives granted to A and B.

In a surviving de-merger, if there is no change in the nature of the enterprise and the conditions for granting tax incentives, the surviving enterprise can continue to enjoy the pre-de-merger tax incentives of the surviving enterprise for the remaining incentive period. Such tax incentive amount is calculated based on the taxable income of the enterprise for the year prior to the merger multiplied by the ratio of the surviving enterprise's assets after the de-merger over the total assets of the pre-de-merger enterprise. If the enterprise had a loss in the year prior to the de-merger, the taxable income is considered to be zero.[98]

The merger and acquisition tax circular does not define "surviving de-merger" or "the surviving enterprise" for a de-merger. A surviving de-merger is defined in merger regulations concerning foreign invested enterprises issued by the predecessor of the Ministry of Commerce and the Sate Administration for Industry and Commerce as "one company is divided into two or more companies; the current company survives and sets up one or more new companies."[99] An old tax circular concerning the mergers and de-mergers of foreign invested enterprises also provides for a definition of surviving de-merger. According to the old tax circular, a surviving de-merger refers to a de-merger where the original enterprise survives and part of it is spun off as one or more new enterprises.[100] In reference to the definition of surviving de-merger in those regulations, a surviving enterprise in a de-merger should be the de-merged enterprise or the original enterprise after the de-merger and should not be the spin-off enterprise or the new enterprise. Based on this assumption, the implementation of the tax incentive formula can be illustrated in the following example.

For example 3: X was granted for CIT exemption for 2008 and 2009 and 12.5 percent CIT rate for 2010, 2011, and 2012. The normal tax rate after tax holiday is

[98] Article 9 of Cai Shui [2009] No. 59.

[99] Article 4 of the Measures for Mergers and De-mergers of Foreign Invested Enterprises, Wai Jing Mao Fa Fa [1999] No. 395, issued by Ministry of Foreign Trade and Economic Cooperation and the State Administration for Industry and Commerce on September 23, 1999, amended in accordance with the Oder of the Ministry of Foreign Trade and Economic Cooperation and the State Administration for Industry and Commerce on November 22, 2001.

[100] Article 2 of the Provisional Measures for Income Tax Treatment of Reorganizations Such as Merger, De-merger, Equity Restructuring, and Asset Transfer for Foreign Invested Enterprises, Guo Shui Fa [1997] No. 71, issued by the SAT on April 28, 1997 and effective till December 31, 2007.

25 percent. X transfers 50 percent of its assets and liabilities into a newly established enterprise Y on July 1, 2009. There is no change of nature of business after the merger. The table below illustrates the tax results with and without de-merger.

Year	Without de-merger		With de-merger			
	X		X		Y	
	Income	CIT	Income	CIT	Income	CIT
2008	100	0	100	0	n/a	n/a
2009	200	0	150	25	50	12.5
2010	300	37.5	150	31.25	150	37.5

Without the de-merger, X would pay no CIT in 2009 and a 12.5 percent CIT on all taxable income in 2010. After the de-merger, X can continue to enjoy tax incentives. However, X's tax incentive is computed based on the taxable income of X for 2008 multiplied by the asset allocation ratio. As X transfers 50 percent of its total assets to Y at the de-merger, it appears that the tax incentive amount for X after the de-merger is RMB50 (RMB100 x 50%/100%). As such, for 2009, the tax exemption will only apply to RMB50 of its total taxable income of RMB150, which includes RMB100 generated for January to June and RMB50 for July to December. Similarly, for 2010, a reduced CIT rate of 12.5 percent would only apply to RMB50 of X's total taxable income; the remaining RMB100 of taxable income would be subject to 25 percent CIT rate. Y cannot enjoy any tax incentives.

The tax incentive rules for mergers and de-mergers apply to both special reorganization and ordinary reorganization. The main reason for special reorganization treatment (i.e., tax deferral) is the continuity of business and ownership interest in a changed business form. Tax incentives are granted to enterprises; the change of ownership generally will not disqualify tax incentives of enterprises. As such, there should be no different tax incentive rule for special reorganization and ordinary reorganization. There is an exception for the tax incentives granted because of certain owner interest. For example, under the old tax law, foreign invested manufacturing enterprises were granted for tax holidays. If a foreign invested enterprise becomes a domestic company because of the ownership change, such ownership change does disqualify the tax holiday to the enterprise. However, such ownership change is not correlated to the classification of special reorganization and ordinary reorganization.

It is not clear why the merger and acquisition tax rule penalizes mergers and de-mergers with respect to tax incentives. Perhaps it is not the intention of the tax circular. Perhaps the MOF and/or the SAT will issue a new circular to clarify the matter.

7.7 Contribution of Assets in Enterprise Formation

An enterprise sometimes may form a new company by contributing some of its assets. An enterprise may also set up such company jointly with another owner or owners by contributing the assets. The current merger and acquisition tax circular does not specifically address the tax treatment of the formation of a company by contributing business assets. A tax circular issued under the EIT Regulations provide that where an enterprise contributes non-monetary business assets to another enterprise in exchange for the equity of the other enterprise, the contributing enterprise is considered selling its assets at fair market value at the time of contribution and then invests in the receiving enterprise. The contributing enterprise should recognize gain or loss on the deemed sale of assets. If the enterprise has difficulty paying CIT on the full gain in one tax year because of a large amount of gain, the enterprise may recognize the gain evenly over five years upon the approval of the tax authorities.[101] Technically, the circular is no longer valid because the EIT Regulations have been replaced by the CIT Law. According to Article 75 of the CIT Implementation Rules, unless otherwise provided by the MOF and the SAT, a transfer of asset in enterprise reorganization is a taxable event. Neither the merger and acquisition tax circular nor any other circular issued under the CIT Law and the CIT Implementation Regulations provide a tax relief for equity investment in kind. Accordingly, the two-step treatment of transfer of business assets for equity investment as provided in the old tax circular should still be valid in principle. However, the five-year gain recognition rule is no longer available; the contributing enterprise should recognize the full gain on the transfer of assets.[102]

Although there is no tax relief for contributing assets to form a new enterprise, it is possible the transaction may be qualified as a special reorganization if it meets the requirements of one of the types of special reorganization as provided in the merger and acquisition tax circular. A formation of enterprise could be a qualified asset acquisition. Suppose that Company A and Company B form a new Company C. A contributes 75 percent of its total assets and B contributes cash. A and B each receives 50 percent of equity of C. Assuming C does not substantially change the use of the assets received from A, the transaction arguably should be qualified as an asset acquisition in a special reorganization. In such case, A should not need to recognize gain or loss on the asset contribution. A's tax basis in its equity in C is equal to its tax basis in the assets immediately before the contribution. C's tax basis in the assets should be equal to A's tax basis in the assets immediately before the contribution. Whether such characterization of "asset acquisition", rather than "contribution" is subject to test in practice.

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[101] Article 3 of the Notice on Certain Income Tax Issues Concerning Equity Investment of Enterprises, Guo Shui Fa [2000] No. 118, issued by the SAT on June 21, 2000.

[102] SAT Gong Gao [2010] No. 19.

Similarly, can a formation of enterprise be qualified as a stock acquisition? Suppose that Company X owns 100 percent equity of Company Y. X contributes 100 percent of Y stock of into a newly formed Company S in exchange for 100 equity of S. As a result, X owns 100 percent of S, which in turn owns 100 percent of Y. Arguably, the contribution of Y stock into S can be characterized as a stock acquisition in special reorganization. X should not recognize gain or loss on the contribution of Y stock. X's tax basis in S should be equal to its tax basis in Y immediately before the contribution. S's tax basis in Y should be equal to X's tax basis in Y immediately before the contribution.

7.8 Financing Acquisition

7.8.1 DEBT AT THE SUBSIDIARY LEVEL

The common and easiest way to push acquisition debt to the subsidiary level is that the subsidiary borrows funds and then acquires assets of a target company.

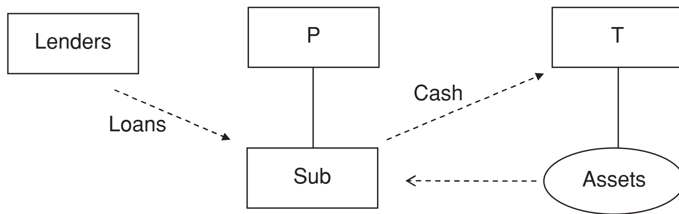

FIGURE 7.8.1–1

This will be a taxable asset acquisition. T will recognize gain or loss on sale of assets to Sub. Sub's tax basis in T's assets will be the consideration paid for the assets. If Lenders are unrelated financial institutions, the interest paid by Sub to Lenders is generally fully deductible. However, if the debt is guaranteed by P or any other related parties of Sub, the debt will be treated as related party debt for computation of limitation on interest expenses under the thin capitalization rule. The maximum related party debt to equity ratio is 5:1 for financial enterprises and 2:1 for other enterprises under the thin capitalization rule. The interest on related party debt exceeding the permitted amount will not be deductible when computing taxable income for CIT purposes.[103] If Sub is high leveraged and related party debt including those guaranteed by P exceeds the debt to equity ratio, Sub may be able to deduct interest expense if it can prove the lending is an arm's-length transaction or, in domestic transactions, the Sub's effective CIT burden is not higher than the lender's. See Chapter 5.4 for discussions of the thin capitalization rule. If, instead of

[103] Article 46 of the CIT law; Cai Shui [2008] No.121.

third-party lending, P makes a loan to Sub to acquire T's assets, the interest deduction will be subject to the same thin capitalization rule. If P is a foreign company and makes a loan Sub, Sub will need to register the foreign debt under foreign exchange rules. The foreign debt is subject to the limitation under registered capital and total investment ratio as outlined in Chapter 5.4.

Technically, a reverse merger can be used for a leverage buyout with debt at subsidiary level. The transaction is illustrated in Figure 7.8.1–2 below.

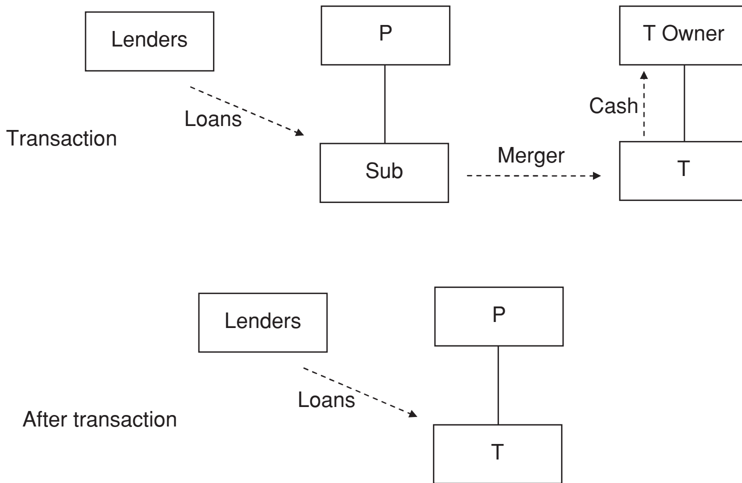

FIGURE 7.8.1–2

P forms a new Sub with equity from P and debts from Lenders. Sub is merged into T; T Owner receives cash at the merger. The two steps most likely will be treated as one single transaction. The possible result is that T is treated as selling all of its assets and then being liquidated into T Owner. T and T Owner should recognize gain or loss on the deemed sale and liquidation. If the debt is guaranteed by P or its related party, the limitation on interest expense under thin capitalization will apply. The tax treatment is the same as that of related party debt in an asset acquisition in the first example. In practice, for non-tax reasons, a reverse merger in leverage buyout may be difficult to implement. For business administration purpose, the registered capital of surviving enterprise is generally the sum of all the merger entities. The reversed merger in our example may require a reduction in registered capital. If one of the merger entities is a foreign invested enterprise, the merger will require the government approval. The government may review the transaction as reduction of capital and not give approval.

7.8.2 DEBT AT PARENT LEVEL

A parent company can leverage in an acquisition of equity of target.

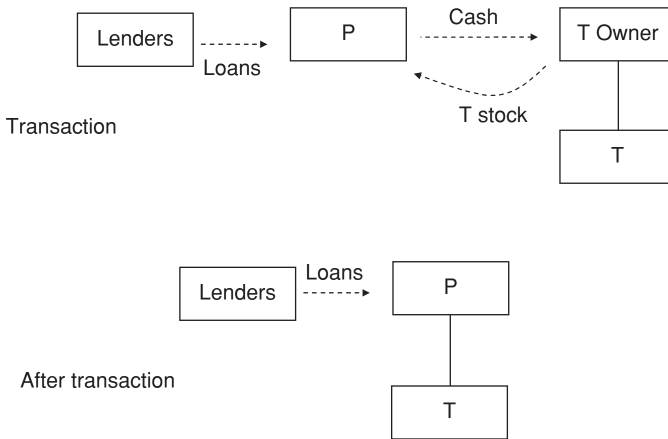

FIGURE 7.8.2–1

The transaction as illustrated in Figure 7.8.2–1 is a taxable stock acquisition. T owner recognizes gain or loss on the sale of T stock. P's tax basis in T stock is the consideration paid to T Owner. When a foreign company acquires an enterprise in China, P can be an existing or newly established holding company incorporated outside China. The loans to an offshore entity are not subject to the China thin capitalization rule unless the offshore entity is a resident enterprise by reason of effective management in China. The advantage of keeping debt at parent level is to simplify the transaction while maintaining leverage in the acquisition of stock. It is also a way to obtain additional borrowing when T is already highly leveraged. The disadvantage of leveraging P is that the interest cannot be deducted by T. Furthermore, T cannot pay dividends to P if it does not have accumulated earnings and profits. As such, if T has excess cash while not having accumulated profits, the cash will not be available to serve P's debt.

7.9 Indirect Transfer of Resident Enterprise by Non-resident Enterprise

According to Article 7 of the Implementation Rules, the income from the transfer of equity investment should be sourced to the location of invested enterprise. Based on this sourcing rule, if a non-resident enterprise owns an overseas holding company, a non-resident enterprise, which in turn invests in a China resident enterprise, the gain on sale of shares of the overseas holding company should be sourced to the location of the overseas holding company and generally would not be taxable in China. However, the SAT in a tax circular provides that if the overseas holding company is located in a jurisdiction where the effective tax burden is less than 12.5 percent or where the jurisdiction does not tax offshore income, the non-resident transferor will be required to provide the Chinese

tax authority in charge, within 30 days of execution of share transfer agreement, the following:[104]

(1) Share transfer agreement;
(2) The information of relationship between the non-resident transferor/investor and the overseas holding company transferred in the areas of capital, business, purchase and sales, etc.;
(3) The information of production, business, personnel, accounting, property, etc. of the overseas holding company transferred;
(4) The information of relationship between the overseas holding company transferred and the Chinese resident enterprise in the areas of capital, business, purchase and sales, etc.;
(5) The explanation of reasonable commercial purpose for the establishment of the overseas holding company transferred; and
(6) Other information that may be required by the tax authority.

If the tax authority in charge believes that the indirect transfer of equity interest in the Chinese resident enterprise is to avoid China tax by abusing organizational form and without reasonable commercial purpose, the tax authority may re-characterize the equity transfer based on economic substance and disregard the overseas holding company. Such re-determination of nature of transfer must be reported by the tax authority in charge to and confirmed by the SAT.[105]

The indirect transfer-reporting rule does not apply to the transfers of shares that are bought and sold on stock exchanges.[106] Accordingly, if a non-resident enterprise purchases shares, on a stock exchange, of a listed offshore company that owns China resident enterprises, the non-resident enterprise is not required to report the sale of these shares of listed offshore company on the stock exchange. It appears that this exception is not available for a non-resident enterprise that acquired shares of the offshore company before the shares are listed on stock exchange (i.e., not bought on exchange) and subsequently sells the shares on a stock exchange after an IPO.

7.10 China Implementation of Global Mergers and Acquisitions

As discussed in Chapter7.5.8, the merger and acquisition circular provides very limitation situations where a cross-border transaction can be qualified as a special reorganization. As such, it is very difficult to structure the China implementation of a global merger or

[104] Article 5 of Guo Shui Han [2009] No. 698.
[105] Article 6 of Guo Shui Han [2009] No. 698.
[106] Article 1 of Guo Shui Han [2009] No. 698.

acquisition as a special reorganization. For taxable global acquisitions, local transactions are often needed to implement the global deal with respect to the equity or assets of China subsidiaries.

7.10.1 GLOBAL MERGER WITH DIRECT CHINA SUBSIDIARIES

In Figure 7.10.1–1, A, a non-resident enterprise, directly owns 100 percent of WFOE1, a resident enterprise in China. B, a non-resident enterprise, directly owns 100 percent of WFOE2, a resident enterprise in China. B is merged into A.

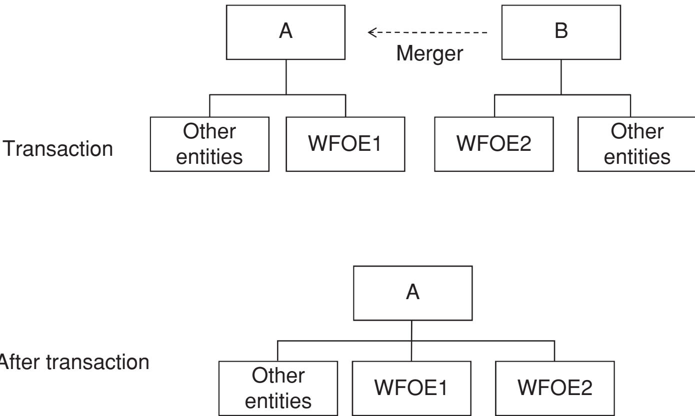

FIGURE 7.10.1–1

B transfers all of its assets and liabilities into A. For China purposes, B transfers equity of WFOE2 to A. According to Article 7(1) of Cai Shui [2009] No.59, to qualify a foreign-to-foreign transfer for a special reorganization, the transferor must directly own 100 percent of the transferee. Because B does not own A, the foreign merger will trigger a gain recognition event in China. B would be treated as selling the equity of WFOE2 to A at fair market value.

7.10.2 GLOBAL MERGER WITH INDIRECT CHINA SUBSIDIARIES

As illustrated in Figure 7.10.2–1, A, a non-resident enterprise, owns 100 percent a SubA, a non-resident enterprise. SubA owns 100 percent of WFOE1, a resident enterprise in China. B, a non-resident enterprise, owns 100 percent of SubB, a non-resident enterprise. SubB owns 100 percent of WFOE2, a resident enterprise in China. B is merged into A.

The transfer of SubB to A generally should not trigger a tax event in China, as there is no direct transfer of WFOE2. However, as discussed in Chapter 7.9, A may need to report the indirect transfer to the Chinese tax authority in charge of WFOE2. Assuming the

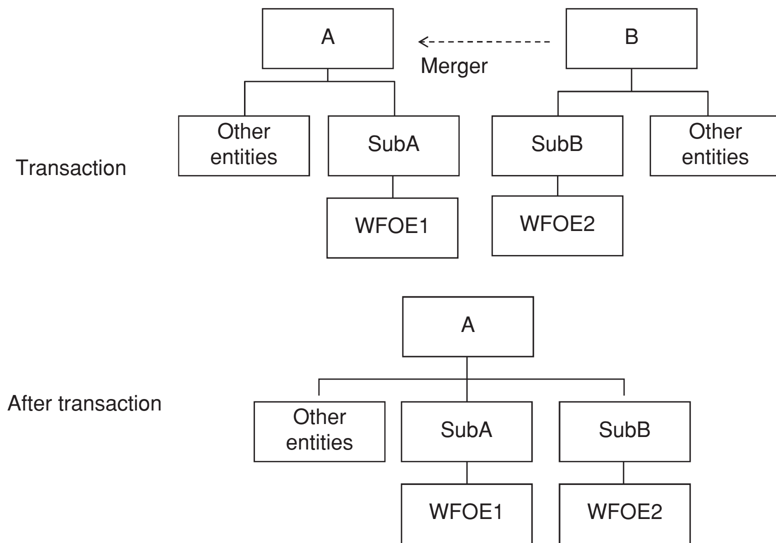

FIGURE 7.10.2–1

merger has a reasonable commercial purpose, the merger most likely will not trigger China tax. Any subsequent business combination in relation to China may trigger a taxable event. For example, if SubB is merged into SubA, SubB would be treated as selling WFOE2 to SubA at fair market value. Suppose, instead of SubA and SubB merger, WFOE2 is merged into WFOE1. The merger tax rule does not address this type of transaction. The transaction seems to satisfy the requirements for a merger in special reorganization except SubA and SubB are non-resident enterprise. Such transaction could be viewed as a cross-border acquisition. As this transaction is not one of three types of cross-border transactions as prescribed in Article 7 of Cai Shui [2009] No.59, it would not be qualified as a special reorganization. However, the three types of cross-border transactions prescribed in Article 7 of Cai Shui [2009] No.59 are "stock and asset acquistions". A merger is a separate type of reorganization from stock acquisition and asset acquisition. One view is that the merger of WFOE2 into WFOE1 should not be diaqualfied as a special reorganization by Article 7 of Cai Shui [2009] No.59 and such merger should qualify for a special reorganization under Article 6(4) of Cai Shui [2009] No.59.

7.10.3 TAXABLE ASSET ACQUISITION

When a non-resident multinational company acquires assets from an unrelated party in a taxable transaction, some of the assets may be located in China. Suppose A, a non-resident enterprise, acquires one line of business from B, also a non-resident enterprise.

B owns 100 percent of China SubB, a wholly foreign owned enterprise in China. The assets sold by B to A include one of the production lines of China SubB.

Except in some special industries, a foreign company generally is not permitted to conduct business in the form of branch. A must have a Chinese entity to own and operate the acquired production lines in China. If A has an existing subsidiary in China, A's China subsidiary can purchase the China assets directly from China SubB. If A does not have an existing entity in China or does not want to use an existing entity to host those assets, A will need to set up a new enterprise in China. Technically, A has two options. A can set up a wholly foreign owned enterprise in China. Let's call it China SubA. A can contribute cash into China SubA. China SubA then can purchase the assets from China SubB. Alternatively, A can purchase the assets directly from China SubB and then from China SubA by contributing the assets acquired. Because of the complications of acquisition and the contribution of assets by foreign companies, the first option is the preferable choice.

The CIT consequences of all those options are similar as the transaction is a taxable purchase of assets from a China resident enterprise, China SubB. Let's assume that A uses China SubA, which can be either an existing or newly established entity, to acquire the assets from China SubB. China SubB will recognize gain or loss on the sale of assets to China SubA. China SubA's tax basis in the assets is the consideration paid to China SubB. One important China tax issue is price allocation. As a global deal, the parties usually negotiate a global price for all the assets acquired. A portion of the global price must be reasonably allocated to China assets. Such allocation should be based on fair market value of assets. The purchase price should be paid by China SubA to China SubB. as it is a transaction between two Chinese entities within China, the cash consideration should be paid in Chinese currency RMB.

7.10.4 TAXABLE STOCK ACQUISITION

A non-resident enterprise B acquires a business from another non-resident enterprise S. The business acquired includes companies and assets in many countries, including an operating Chinese subsidiary, China Sub, which is 100 percent owned by S. To implement the global transaction, S most likely will enter into a share purchase agreement with B or B's subsidiary to sell the equity of China Sub to B or B's subsidiary. This is an ordinary reorganization; S should recognize gain or loss on the transfer of equity of China Sub. The key issue in a transaction like this is the allocation of purchase price among the assets. Such price allocated to China Sub must be reasonable.

Where a foreign investor (or an actual control person) transfers the equity of more than one "controlled companies" within or outside China at the same time, the resident enterprise transferred should provide the tax authority in charge with the agreement on the whole transfer and the agreement relevant to the resident enterprise. If there is no agreement relevant to the resident enterprise, the resident enterprise should provide the

tax authority with the detailed information of each holding company and appropriately allocate the transfer price to the resident enterprise. If such price cannot be accurately allocated, the tax authority may make a transfer pricing adjustment using reasonable method.[107] The term "controlled company" is not defined. Presumably, the foreign investor should own or actually control more than 50 percent of equity of the transferred companies.

7.11 Consideration of Taxes Other than CIT

In addition to CIT, a merger or acquisition may trigger other China taxes. The other taxes sometimes are crucial factors to determine the transaction structure. This section provides a brief overview of major China taxes other than CIT that may be applicable in a merger or acquisition. The discussions in this section are based on general tax rules and do not cover special rules applicable to special industries and all the exceptions to the general rules.

7.11.1 VALUE ADDED TAX

Value Added Tax (VAT) is imposed on the sale of goods within China, the provision of processing and repair services, and the importation of goods into China.[108] Regular VAT rate is 17 percent.[109] A reduced rate of 13 percent applies to some goods.[110] Limited items are exempted from VAT.[111] There are two types of VAT payers, general VAT payer and small-scale VAT payer. Generally speaking, an enterprise should register with the tax authority as a general VAT payer if its annual VATable revenue is greater than RMB500,000 for an entity that is primarily engaged in manufacturing goods or providing VATable

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[107] Article 8 of Guo Shui Han [2009] No. 698.

[108] Article 1 of Provisional Regulations of Value Added Tax, adopted by the State Council on November 5, 2008, issued by Order of State Council 538 on November 10, 2008, and effective on January 1, 2009.

[109] Article 2 of Provisional Regulations of Value Added Tax.

[110] According to Article 2 of Provisional Regulations of Value Added Tax, those goods include (1) food grains and edible vegetable oils; (2) tap water, heating, air conditioning, hot water, coal gas, liquefied petroleum gas, natural gas, methane gas, and coal/charcoal products for household use; (3) books, newspapers, and magazines; (4) feeds, chemical fertilizers, agricultural chemicals, agriculture machinery, and covering plastic film for farming; and (5) other goods as prescribed by the State Council.

[111] According to Article 15 of Provisional Regulations of Value Added Tax, the items that are exempt from VAT include (1) self-produced agricultural products sold by agriculture producers; (2) contraceptive medicines and devices; (3) antique books; (4) the importation of instruments and equipment directly used in scientific research, experiment and education; (5) the importation of materials and equipment from foreign governments and international organizations as assistance free of charge; (6) articles imported directly by organization for the disabled and solely for use by the disabled; and (7) the sale of goods which have been used by the sellers.

services or greater than RMB800,000 for an entity that is engaged in other VATable business such as whole sales or retails. VAT payers whose annual sales are below this threshold should be small-scale VAT payers.[112] A general VAT payer will pay VAT at regular VAT rate. Input tax incurred by a general VAT payer on its purchases may be credited against output tax charges on its sales. On or after January 1, 2009, small-scale VAT payers pay VAT at 3 percent.[113] Small-scale VAT payers cannot claim credit on VAT incurred on purchase. For the purpose of illustration VAT implications of mergers and acquisitions, we will assume all parties in the transactions are general VAT payers.

VAT is not applicable in a stock acquisition. In an asset acquisition, the transfer of certain assets is subject to VAT. These assets mainly include inventories and fixed assets. For inventories, the seller should pay VAT at regular rate. The seller will charge the VAT to the buyer. The buyer can claim input tax credit on its subsequent sales of goods. For example, if the price net of VAT allocated to inventories is RMB100 and the VAT rate for the goods is 17 percent, the seller will charge the buyer RMB117. The seller will pay RMB17 of VAT less any input tax credit it may have to the tax authorities. Suppose the buyer sells the inventories for RMB150 after the acquisition, output tax for the buyer will be RMB25.5 (RMB150 x 17%). The buyer can claim a credit of RMB17. The buyer's VAT payable is RMB8.5 (RMB25.5 – RMB17). As illustrated in the example, VAT on inventories generally should not increase or decrease tax liability, and is merely a timing difference. Given that inventories generally will turn in a short period of time, the payment of VAT on transfer of inventories in asset acquisitions usually should not be a major issue.

VAT on the transfer of fixed assets is more complex because of the change of VAT regulations in 2008. Prior to January 1, 2009, the recovery of input VAT incurred on the purchase of fixed assets is disallowed. This means that the VAT incurred by an enterprise in acquisition of fixed assets became part of the cost base in computing depreciation for CIT purposes, but the amount of VAT could never be credited against output tax on sales of products by an enterprise. Certain VAT relief on purchases of equipment was granted to certain enterprises. VAT exemptions on the import of equipment and VAT refunds on the purchase of domestically produced equipment were available to qualified enterprises, especially to certain foreign invested enterprises. Foreign investments in China are classified as "encouraged," "permitted," "restricted," and "prohibited" categories under the foreign investment catalog. If a foreign invested enterprise is classified as "encouraged," the enterprise was eligible for VAT exemption on imported equipment for its own use up to its approved amount of total investment, unless the imported item is on a list of non-exempted items. If such "encouraged" foreign invested enterprise purchased domestically produced equipment within China, the enterprise could claim a VAT

[112] Article 28 of the Implementation Rules of Provisional Regulations of Value Added Tax, Order of MOF and SAT No. 50, issued by the MOF and the SAT on December 15, 2008 and effective on January 1, 2009.

[113] Article 12 of Provisional Regulations of Value Added Tax.

refund for the input VAT incurred on the purchase of such equipment. Prior to January 1, 2009, the sale of fixed asset was exempted from VAT if the sale price is not greater than the original costs of the assets.

On July 1, 2004, China started trial implementation of VAT reform Liaoning, Jilin, and Heilongjiang Provinces of the North-eastern Area. Enterprises in six industries (equipment manufacturing, petroleum chemical, metallurgy, ship manufacturing, automobile manufacturing, and processing of agriculture products) were allowed to credit VAT incurred on purchase of certain fixed assets.[114] In July 2007, the trial implementation was expanded to an additional 26 cities in 6 provinces in Central Area (Shanxi, Anhui, Jiangxi, Henan, Hubei, and Hunan) in 8 industries,[115] and subsequently to East area of Inner-Mongolia[116] and Wenchuan earthquake area.[117] In November 2008, VAT Regulations were amended and the new policy on fixed assets was adopted in the amended VAT Regulations. On and after January 1, 2009, general VAT payers are allowed to recover input VAT incurred on the purchase of certain fixed assets, including machines, machinery, means of transportation (excluding cars, motorcycles and yachts that are subject to consumption tax and could be used for private purposes), and other equipment and tools related to production and operation. On January 1, 2009, the preferential VAT policy on exemption of import VAT and VAT refunds on purchases of domestically produced equipment was abolished.[118]

Because of the VAT reform, VAT on the sale of fixed assets depends on whether the assets were acquired before or after the effectiveness of the amended VAT regulations. In an asset acquisition on or after January 1, 2009, if equipment was originally acquired prior to January 1, 2009 and the seller did not credit VAT incurred on the original asset

[114] The Measures for Certain Issues Concerning Enlargement of Scope of Credit for Value-added Tax in North-eastern Area, Cai Shui [2004] No. 156, issued by the MOF and the SAT on September 14, 2004 and effective from July 1, 2004 to December 31, 2008.

[115] The Measures for Certain Issues Concerning Enlargement of Scope of Credit for Value-added Tax in Central Area, Cai Shui [2007] No. 75, issued by the MOF and the SAT on May 11, 2007 and effective from July 1, 2007 to December 31, 2008.

[116] The Measures for Certain Issues Concerning Enlargement of Scope of Credit for Value-added Tax in East Area of Inner-Mongolia, Cai Shui [2008] No. 94, issued by the MOF and the SAT on July 2, 2008 and effective from July 1, 2008 to December 31, 2008.

[117] The Measures for Certain Issues Concerning Enlargement of Scope of Credit for Value-added Tax in Area Severely Damaged by the Wenchuan Earthquake, Cai Shui [2008] No. 108, issued by the MOF and the SAT on August 1, 2008 and effective from July 1, 2008 to December 31, 2008.

[118] Article 7 of the Notice on Certain Issues Concerning Implementation of VAT Reform Throughout China Cai Shui [2008] No. 170, issued by the MOF and the SAT on December 19, 2008 and effective on January 1, 2009. However, on August 20, 2009, the MOF, National Development and Reform Commission, the Ministry of Industry and Information, General Administration of Customs, the SAT, and National Energy Board issued the Notice on Adjustment to Tax Policy on the Import of Key Technology Equipment, Cai Guan Shui [2009] No. 55, which provides for Customs and VAT exemption on the import of equipment on an equipment list. As such exemption is not broadly available, we will not discuss it in this book.

purchase (i.e., the seller is not in the VAT reform trail implementation area or otherwise not benefited from the trail implementation), the seller will pay 2 percent VAT on the used equipment sale.[119] It appears that the buyer is not permitted to credit this 2 percent VAT because only ordinary invoices (not VAT invoices) can be issued on such used equipment sale.[120] If the equipment was imported and the seller was exempted from VAT on the import or if the equipment was domestically produced and the seller received VAT refund on the domestic purchase, the VAT exemption and VAT refund are subject to recapture if the equipment is disposed of within a specific period. For most equipment, this period is five years. As such, if the asset acquisition takes place during the five-year period, the seller will need to pay back a portion of amount of VAT previously exempted or refunded. For the transfer of imported equipment, the claw-back of VAT exemption is calculated based on the original import price discounted by applying the following formula:

$$\begin{aligned}\text{Tax base} = {} & \text{Original import price confirmed by Customs} \\ & \times \left(1 - \text{Number of months since import} \div \text{Supervision period} \times 12\right)\end{aligned}$$

The "number of months since import" is the actual number of months from the date of original release of equipment from Customs, if the number of days owing the equipment in a month is less than a month but 15 days or more, those days will be treated as one month; if less than 15 days, those days will be treated as zero months.[121] The VAT payable will be the tax base times the applicable VAT rate (e.g., 17 percent for a general VAT payer).

For the transfer of domestically produced equipment, the amount of payback for VAT refund is calculated using the following formula:

$$\text{VAT payable} = \text{Net value of equipment} \times \text{Applicable tax rate}$$

The net value of equipment is the book value net of accumulated depreciation in accordance with China accounting standards.[122]

[119] Article 4 of Cai Shui [2008] No. 170.

[120] The Notice on Relevant Administrative Issues Concerning Simplified VAT Collection Methods, Guo Shui Han [2009] No. 90 issued by the SAT on February 25, 2009 and effective on January 1, 2009.

[121] Article 45 of the Administrative Measures for Exemption or Reduction of Tax on Import and Export of Goods, Order of General Administration of Customs No. 179, issued by General Administration of Customs on December 29, 2008.

[122] The Notice on the Termination of Tax Refund Policy for Purchase of Domestically Produced Equipment by Foreign Invested Enterprises, Cai Shui [2008] No. 176, issued by the MOF and the SAT on December 25, 2008.

The VAT incurred on or after January 1, 2009 as a result of claw-back of VAT exemption generally will be creditable for a general VAT payer.[123] Although the tax circular specifically addresses input tax credit for the claw-back of VAT exemption on imported equipment, the same policy should apply to the claw-back of VAT refund on domestically produced equipment.

In an asset acquisition on or after January 1, 2009, if equipment was originally acquired on or after January 1, 2009 or, although acquired before January 1, 2009, the seller credited VAT incurred on the original asset purchase (i.e., the seller is in the VAT reform trail implementation area), the seller will pay VAT on the used equipment sale at the normal VAT rate,[124] which is 17 percent for a general VAT payer for most types of equipment. The buyer should be able to credit the VAT. However, this rule does not apply to the fixed assets that are not VAT creditable such as certain cars, motorcycles, and yachts. The transferor of used fixed assets in those categories should be subject to a 2 percent VAT[125] and such VAT is not creditable for the purchaser.[126]

VAT regulations do not address whether VAT is applicable to a merger or de-merger. As VAT is levied on the transfer of goods, including a transfer between branches with separate accounting within the same legal entity, there should be sufficient basis to argue that a merger and de-merger involving a transfer of goods is a VATable event. On the other hand, it is possible to rely on a SAT circular concerning the transfer of entire business to argue no VAT. The SAT in that circular stated that the transfer of an entire business including all the assets, liabilities, and employees of an entity is not subject to VAT.[127] In practice, the surviving company sometimes may find it difficult to claim credit for the VAT incurred by the merged entity. One of the reasons for this difficulty is that the VAT invoices were issued to a merged entity (with merged entity's name). The system may not recognize the VAT credit claim for voices issued to other taxpayers. To simplify the process, the merged entity may sell inventories to the surviving entity. By doing so, the merged entity can utilize its VAT credit on the sale; the surviving entity will have VAT invoices issued by the merged entity to the surviving entity.

The application of VAT exemption on the transfer of an entire business is narrowly interpreted. In a case where a company listed on a stock exchange transferred its assets and liabilities to a controlled company while the transferor remained as a listing company statutes, the SAT ruled that such transfer is not qualified as "the transfer of entire business"

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[123] The Reply on the Issue of Input Tax Credit on the Claw-back of VAT Exemption as a Result of Early Termination of Customs Supervision Period, Guo Shui Han [2009] No. 158, issued by the SAT on March 30, 2009.

[124] Cai Shui [2008] No. 170.

[125] Cai Shui [2008] No. 170; Cai Shui [2009] No. 9.

[126] Guo Shui Han [2009] No. 90.

[127] The Reply on the Issue of No VAT on Transfer of Entire Business, Guo Shui Han [2002] No. 420, issued by the SAT on May 17, 2002.

for VAT exemption purposes and the transferor is subject to VAT on the transfer of VATable assets. The SAT further provides that if the transferee invests those assets to another company as capital investment, the investor should also be subject to VAT on the contribution.[128]

7.11.2 BUSINESS TAX

Business Tax is imposed on the provision of services and the transfer of immovable properties and intangibles.[129] A sale of equity investment is not subject to Business Tax. Business Tax rates are 3 percent to 20 percent. The tax rate for the transfer of immovable property and intangibles is 5 percent. In an asset acquisition, if the assets include land use right, building and structure, or intangibles (patent, trademark, goodwill, etc.), the seller should pay Business Tax on the transfer of those assets. The Business Tax base for the transfer of land use rights is the sale price allocated to the land use rights less the cost of original acquisition of the land use rights. If the seller originally purchased immovable property (e.g., building and structure), the Business Tax base for the transfer of the immovable property should be the sale price allocated to the immovable property less the original acquisition cost.[130] If the seller constructed the immovable property by itself, the Business Tax base is the sale price allocated to the immovable property without any deduction. The Business Tax base for the transfer of intangibles is the gross receipt of transfer price. Unlike VAT, Business Tax is not recoverable. Business Tax paid by the seller can be deducted in computing gain on asset sale for CIT purposes. Business Tax often makes a significant difference between stock acquisition and asset acquisition in term of taxes paid by the seller on the transaction as stock sale is not subject to Business Tax.

Business Tax regulations do not address whether Business Tax is applicable to a merger or de-merger. One school of thought is that Business Tax is applicable if immovable properties or intangibles are transferred in a merger or de-merger. However, Business Tax liability occurs on the date that a taxpayer receives payment or the date of payment as provided in a written contract or the date of completion of transaction where there is no written contract or there is no payment date on the contract.[131] In a merger or de-merger,

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[128] The Reply on the Issue of Value-added Tax Policy on Asset Reorganization of Taxpayers, Guo Shui Han [2009] No. 585, issued by the SAT on October 21, 2009.

[129] Article 1 of Provisional Regulations on Business Tax, adopted by the State Council on November 5, 2008, issued by Order of State Council No. 540 on November 10, 2008 and effective on January 1, 2009.

[130] Article 3(12) of the Notice on Certain Business Tax Policies, Cai Shui [2003] No. 16, issued by the MOF and the SAT on January 15, 2003 and effective on January 1, 2003.

[131] Article 12 of Provisional Regulations on Business Tax; Article 24 of the Implementation Rules for Provisional Regulations on Business Tax, issued by the MOF and the SAT on December 15, 2008 and effective on January 1, 2009.

if shareholders merely receive stock, arguably there is no payment and therefore Business Tax should not apply. Another possible support for no tax position is a SAT circular concerning the transfer of entire business. The SAT stated that the transfer of entire business including all the assets, liabilities, and employees of an entity is not subject to Business Tax.[132]

7.11.3 CITY MAINTENANCE AND CONSTRUCTION TAX AND EDUCATION SURCHARGE

City Maintenance and Construction Tax is levied on the transactions subject to VAT, Business Tax, and Consumption Tax.[133] Tax base is the amount of VAT, Business Tax, and Consumption Tax paid. Tax rates are 7 percent for taxpayers in urban districts of cities, 5 percent for taxpayers in towns, and 1 percent for taxpayers in other areas.[134] Similar to City Maintenance and Construction Tax, Education Surcharge is also levied on the transactions subject to VAT, Business Tax, and Consumption Tax.[135] Tax rate is 3 percent of the amount of VAT, Business Tax, and Consumption Tax paid.[136] Before December 1, 2010, foreign enterprises and foreign invested enterprises are exempt from City Maintenance and Construction Tax and Education Surcharge.[137] On and after December 1, 2010, City Maintenance and Construction Tax and Education Surcharge apply to foreign enterprises, foreign invested enterprises, and foreign individuals.[138] As such in an asset acquisition on or after December 1, 2010, if VAT and Business Tax are paid, City Maintenance and Construction Tax and Education Surcharge should be paid by the seller. If the asset cquisition took place prior to December 1, 2010, only domestic seller is subject to those taxes. City Maintenance and Construction Tax and Education Surcharge paid are deductible for the seller in computing gain on asset sale for CIT purposes.

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[132] The Reply on the Issue of No Business Tax on Transfer of Entire Business, Guo Shui Han [2002] No. 165, issued by the SAT on February 21, 2002.

[133] Article 1 of Provisional Measures for City Maintenance and Construction Tax, Guo Fa [1985] No. 19, issued by the State Council on February 8, 1985.

[134] Article 4 of Provisional Measures for City Maintenance and Construction Tax.

[135] Article 2 of Provisional Measures for Education Surcharge, Order of State Council [1990] No. 60, issued by the State Council on June 7, 1990, amended by Order of State Council No. 448 on August 20, 2005.

[136] Article 3 of Provisional Measures for Education Surcharge.

[137] The Notice on Temporary Exemption of City Maintenance and Construction Tax and Education Surcharge for Foreign Invested Enterprises and Foreign Enterprises, Guo Shui Fa [1994] No. 38, issued by the SAT on February 25, 1994.

[138] The Notice on Unification of City Maintenance and Construction Tax and Education Surcharge for Domestic Enterprises, Foreign Invested Enterprises, and Foreign Individuals, Guo Fa [2010] No. 35, issued by the State Council on October 18, 2010 and effective on December 1, 2010.

7.11.4 LAND APPRECIATION TAX

Land Appreciation Tax is levied on the transfer of land use rights, buildings, and attached facilities.[139] The tax base of Land Appreciation Tax is the consideration received from the transfer less allowable deductions.[140] The allowable deductions include (1) the cost of land use right, (2) the costs of developing the land, (3) the cost of construction of a new building and facilities or appraisal value of old building and facilities, (4) transfer taxes, and (5) other allowable costs prescribed by the MOF.[141] Unless transactions are to acquire certain assets of real estate developers, buildings transferred in asset acquisitions most likely will be classified as old buildings. As such, the allowable deduction is determined based on the value of property assessed by a certified asset valuation firm at the time of disposition, discounted by the condition of the property represented in the form of a percentage. The deduction amount for used property is required to be approved by the tax authority.[142]

Land Appreciation Tax rates are as follows:[143]

Taxable amount	Tax rate
Equal to or less than 50% of allowable deductions	30%
More than 50% but equal to or less than 100% of allowable deductions	40%
More than 100% but equal to or less than 200% of allowable deductions	50%
More than 200% of allowable deductions	60%

Land Appreciation Tax paid is deductible for the seller in computing its gain on the asset sale for CIT purposes. In an asset acquisition, Land Appreciation Tax can be a significant amount if the assets transferred include land use rights and immovable properties. Land Appreciation Tax is not applicable to the transfer of stock.

7.11.5 DEED TAX

Deed Tax generally is levied on a transferee for the transfer of land use rights and the ownership of buildings.[144] The tax rate is 3 percent to 5 percent of transfer price.

[139] Article 2 of Provisional Regulations on Land Appreciation Tax, Order of the State Council No. 138, issued by the State Council on December 13, 1993 and effective on January 1, 1994.

[140] Articles 4 of Provisional Regulations on Land Appreciation Tax.

[141] Articles 5 of Provisional Regulations on Land Appreciation Tax.

[142] Article 7 of the Detailed Rules for Implementation of Provisional Regulations on Land Appreciation Tax, Cai Fa Zi [1995] No. 6, issued by the MOF and the SAT on January 27, 1995 and effective on January 27, 1995.

[143] Articles 7 of Provisional Regulations on Land Appreciation Tax.

[144] Article 1 of Provisional Regulations on Deed Tax, Order of the State Council No. 224, issued by the State Council on July 7, 1997 and effective on October 1, 1997.

The governments of provinces, municipalities, and autonomy regions may decide the tax rate within the above range in their jurisdictions.[145] Usually the full payment of Deed Tax is a pre-condition for the government to issue land use rights certificates and property ownership certificates. In an asset acquisition, if the assets include land use rights and immovable property, the buyer will need to pay Deed Tax on the transfer of those assets. In a merger and de-merger where ownership of those assets is changed from one legal entity to another legal entity, the receiving entity should pay Deed Tax.

7.11.6 STAMP DUTY

Each party to a contract or agreement that is drawn up in China and falls within a dutiable category is liable for Stamp Duty at the specified rate based on the value of the contract.[146] The Stamp Duty regulations list 13 categories of dutiable contracts and documents.[147] The duty rates range from 0.005 percent to 0.1 percent depending on the categories of document. A share acquisition agreement is a dutiable document; each party of the agreement should pay Stamp Duty at 0.05 percent of contract price. As both the seller and buyer must pay Stamp Duty, the total Stamp Duty cost of both parties will be 0.1 percent of the contract price. Duty rate for contract of inventory sales is 0.03 percent; the rate for contract of transferring certain property such as building, patent, copyright, and trademark is 0.05 percent.

In an asset acquisition, the business acquired may include various assets such as inventories, patents, trademark, and sometimes even equity investment in other companies. The Stamp Duty regulations do not provide how Stamp Duty is computed for a contract on the purchase and sale of different types of assets. Local tax authorities may have different interpretations in different locations. Tax authorities in many locations agree that if specific contract prices are allocated to items that are in the dutiable categories, Stamp Duty can be computed separately for those dutiable items. However, if there is no specific price allocation, some tax authorities may impose Stamp Duty for the full contract price at the highest rate applicable to a dutiable item covered by the asset purchase and sale contract.

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[145] Article 3 of Provisional Regulations on Deed Tax.

[146] Article 1 of Provisional Regulations on Stamp Duty, Order of the State Council No. 11, issued by the State Council on August 6, 1988 and effective on October 1, 1988.

[147] Dutiable documents include (1) contracts for purchase and sale of goods, (2) contracts for processing services, (3) construction engineering, surveying and design contracts, (4) construction and installation contracts, (5) leases, (6) cargo transportation contracts, (7) warehousing contracts, (8) loan agreements, (9) property insurance contracts, (10) technology contracts, (11) property transfer contracts, (12) business account books, and (13) licenses and ownership certificates issued by government.

7.11.7 CUSTOMS DUTY

Customs Duty is levied on import and export of goods. As most business acquisitions are not involved in a physical transfer of tangible assets across borders, Customs Duty normally will not be a concern of mergers and acquisitions. A common Customs Duty issue is a claw-back of exemption of Customs Duty on import of equipment. Some enterprises are granted for Customs Duty exemption on the import of equipment. For example, foreign invested enterprises in the encouraged category of foreign investment can enjoy Customs Duty exemption on the import of equipment for self-use. The duty-free equipment is subject to a Customs supervision period, usually five years. If an importer transfers the duty-free equipment to others during the supervision period, it is required that a portion of Customs Duty previously exempted be paid back. This is the same issue as claw-back of VAT exemption as discussed in Chapter 7.11.1. The only difference is that whereas VAT exemption was terminated on January 1, 2009, Customs Duty exemption has not been cancelled. As such, if the asset acquisition takes place during the five-year period, the seller must pay back a portion of amount of Customs Duty. The same formula (for claw-back of VAT exemption) is used to compute the duty base for the claw-back of Customs Duty exemption:

$$\text{Duty base} = \text{Original import price confirmed by Customs} \times \left(1 - \text{Number of months since import} \div \text{Supervision period} \times 12\right)$$

8

TAX INCENTIVES

Prior to 2008, different tax incentives were provided under the two CIT systems that were applicable to foreign invested enterprises and domestic enterprises, respectively. The unified CIT Law has provided unified tax incentives to both domestic and foreign invested enterprises. The old tax incentive regime generally encouraged the investment in manufacturing; the current tax incentives focus more on the promotion of the development of technologies, environmental protection, resources conservation, and production safety. This chapter will introduce tax incentives provided under the CIT Law.

8.1 Agriculture, Forestry, Animal Husbandry, and the Fishery Industry

Income derived from certain activities in agriculture, forestry, animal husbandry, and the fishery industry is eligible for CIT exemption.[1] Those activities include:[2]

(1) The growing of vegetables, grains, tuber crops, oil plants, beans, cotton, hemp, sugar crops, fruits and nuts;
(2) The selection and cultivation of new agricultural species;

[1] Article 27(1) of the CIT Law.
[2] Article 86(1) of the CIT Implementation Rules.

(3) The growing of Chinese medicinal herbs;
(4) The cultivation and growing of forests;
(5) The rearing of livestock and poultry;
(6) The harvesting of forestry products;
(7) Irrigation, preliminary processing of agricultural products, veterinary services, promotion of agricultural technologies, operation and maintenance of agricultural machineries and similar agricultural, forestry, animal husbandry, fishery services projects; and
(8) Fishing in the high seas.

The CIT rate applicable to an enterprise engaging in the following projects will be reduced by 50 percent: [3]

(1) The growing of flowers, tea plants, and other crops used for beverages and spices; and
(2) Sea and inland water aquaculture.

8.2 Public Infrastructure

Income derived from certain public infrastructure projects is eligible for three-year CIT exemption and three-year 50 percent reduction in CIT rate, starting from the year in which the project first generates operating income.[4] The CIT exemption starts from the first year when the enterprise derives its initial main business revenue from its operations (including trial operation) after the public infrastructure project is complete.[5] The qualified projects are those involving ports and wharfs, airports, railways, highways, urban public transportation, electric power, and water suppliers, as prescribed in the Catalog of Public Infrastructure Projects Eligible for Preferential Corporate Income Tax Treatment. Qualified projects must be those approved on or after January 1, 2008.[6] Only project owners are eligible for the tax incentives. Enterprises that are engaged, under contract, in the operation or construction of those projects for project owners and receive

[3] Article 86(2) of the CIT Implementation Rules.

[4] Article 27(2) of the CIT Law; Article 87 of the CIT Implementation Rules.

[5] Article 2 of the Notice on the Issues of Corporate Income Tax Incentives for Public Infrastructure Projects Eligible for Key Support from the State, Guo Shui Fa [2009] No. 80, issued by the SAT on April 16, 2009 and effective from January 1, 2008.

[6] The Notice on Certain Issues Concerning the Implementation of the Catalog of Public Infrastructure Projects Eligible For Preferential Corporate Income Tax Treatment, Cai Shui [2008] No. 46, issued by the MOF and the SAT on September 23, 2008.

service fees are not entitled to the tax incentives.[7] The enterprises that are engaged in the construction of those projects for self-use will not be entitled to those tax incentives either.[8] The MOF, the SAT, and the National Development and Reform Commission jointly issued the Catalog of Public Infrastructure Projects Eligible for Preferential Corporate Income Tax Treatment (2008 edition).[9] The new catalog is applicable for the period on or after January 1, 2008.

If, in addition to the income from qualified public infrastructure projects, an enterprise has revenue from any business other than those listed in the catalog, the enterprise should separate the accounts for the other revenue and reasonably allocate period expenses and common expenses. If the enterprise does not maintain such separate accounting, it cannot enjoy the tax incentives. The allocation of period expenses and common expenses can be made in proportion as investment amounts, sales revenue, assets, payroll, etc. Once a method of allocation is selected, the enterprise cannot change the method without the consent of the tax bureau in charge.[10] In order to enjoy the CIT exemption, an enterprise should file certain documents with the tax authority in charge within 15 days after the enterprise generates the initial revenue from the qualified project. Those documents include the copies of the project approval, the project completion verification report, and the project investment capital verification report, as well as other information that the tax authority requests.[11] If the project is no longer qualified for tax reductions or exemptions as a result of change of business of the enterprises or change of the catalog, the enterprise should submit a written report to the tax authority within 15 days after such change and stop enjoying the tax incentives.[12] If a qualified project is transferred during the period of tax exemption or reduction as discussed above, the transferee of such project is eligible for the preferential tax treatment during the remaining tax incentive period. However, if the transfer is made after the period for the tax exemption/reduction has expired, the transferee of the project cannot obtain additional tax exemption or reduction with respect to the same project.[13]

[7] Article 87 of the CIT Implementation Rules; Articles 3 and 4 of Guo Shui Fa [2009] No. 80.

[8] Article 87 of the CIT Implementation Rules; Articles 5 of Guo Shui Fa [2009] No. 80.

[9] The Notice on the Release of the Catalog of Public Infrastructure Projects Eligible For Preferential Corporate Income Tax Treatment (2008 edition), Cai Shui [2008] No. 116, issued by the MOF, the SAT, and National Development and Reform Commission on September 8, 2008 and effective from January 1, 2008.

[10] Articles 6 of Guo Shui Fa [2009] No. 80.

[11] Articles 7 of Guo Shui Fa [2009] No. 80.

[12] Articles 8 of Guo Shui Fa [2009] No. 80.

[13] Article 89 of the CIT Implementation Rules; Articles 9 of Guo Shui Fa [2009] No. 80.

8.3 Environmental Protection and Resources Conservation

Income derived by an enterprise from qualified environmental protection and energy or water conservation projects is eligible for 3-year CIT exemption and 3-year 50 percent reduction in CIT rate, starting from the year in which the project first generates operating income.[14] The qualified environmental protection and energy or water conservation projects include public sewerage treatment, public refuse treatment, synergistic development and utilization of methane, technological innovation in energy conservation and emission reduction, seawater desalination and similar projects.[15] The MOF, the SAT, and the National Development and Reform Commission jointly issued the Catalog of Environmental Protection, Energy and Water Conservation Enterprises for Preferential Corporate Income Tax Treatments (Trial Implementation) upon the approval of the State Council.[16] The catalog provides guidelines for the qualification for projects in public sewerage treatment, public refuse treatment, the development and utilization of methane, technological innovation in energy conservation and emission reduction, and sea water desalination that are eligible for the tax incentive.

If a qualified project is transferred during the period of tax exemption or reduction as discussed above, the transferee of such project is eligible for the preferential tax treatment during the remaining tax incentive period. However, if the transfer is made after the period for the tax exemption/reduction has expired, the transferee of the project cannot obtain additional tax exemption or reduction with respect to the same project.[17]

Enterprises are encouraged to invest in special equipment for purposes of environmental protection, energy and water conservation, and production safety. An enterprise can receive a tax credit equal to 10 percent of the amount invested in the specialized equipment. Such credit may be used against tax payable of the enterprise for the current year; the excess credit may be carried forward for 5 years. To be eligible for the tax credit, an enterprise must purchase and actually use the specialized equipment as prescribed in Catalog of Preferential Corporate Income Tax Treatments for Specialized Equipment in Environmental Protection, Catalog of Preferential Corporate Income Tax Treatments for Specialized Equipment in Energy or Water Conservation, Catalog of Preferential Corporate Income Tax Treatments for Specialized Equipment in Safe Production. Tax benefits will be clawed back if the enterprise subsequently transfers or leases the

[14] Article 27(3) of the CIT Law; Article 88 of the CIT Implementation Rules.

[15] Article 88 of the CIT Implementation Rules.

[16] The Notice on the Release of the Catalog of Environmental Protection, Energy and Water Conservation Enterprises for Preferential Corporate Income Tax Treatments (Trial Implementation), Cai Shui [2009] No. 116, issued by the MOF, the SAT, and the National Development and Reform Commission on December 31, 2009 and effective from January 1, 2008.

[17] Article 89 of the CIT Implementation Rules.

equipment within 5 years.[18] On August 20, 2008, the MOF, the SAT, and the National Development and Reform Commission jointly issued the Catalog of Preferential Corporate Income Tax Treatments for Specialized Equipment in Environmental Protection (2008 edition) and the Catalog of Preferential Corporate Income Tax Treatments for Specialized Equipment in Energy or Water Conservation (2008 edition);[19] the MOF and the SAT, and the State Administration of Work Safety jointly issued the Catalog of Preferential Corporate Income Tax Treatments for Specialized Equipment in Safe Production (2008 edition).[20] These new catalog are applicable for the period on or after January 1, 2008.

Enterprises are encouraged to effectively use resources. An enterprise may exclude 10 percent of its revenue derived from the manufacture of products that are in line with state industrial policy and involve the synergistic utilization of resources in computing taxable income.[21] On August 20, 2008, the MOF, the SAT, and the National Development and Reform Commission jointly issued the Catalog of Preferential Corporate Income Tax Treatments of Synergistic Utilization of Resources (2008 edition).[22] The new catalog is applicable for the period on or after January 1, 2008. To be eligible for the income exclusion, an enterprise must derive revenue from the use of the resources prescribed in the catalog as the raw materials in the production of goods. The proportion of the amount of raw materials used in production shall not be lower than the criteria prescribed in the catalog.[23]

To qualify for tax incentives for income derived from synergistic utilization of resources, the enterprise not only needs to conduct activities described by the catalog, but also have separate business revenue derived from such activities. A cement manufacturing enterprise generated electricity using heat by-product through cement kiln in manufacturing process, which qualifies for activities listed in the Catalog of Preferential Corporate Income Tax Treatments of Synergistic Utilization of Resources. However, the electricity generation activities were operated by a non-legal person division of the cement company and not a separate taxpayer. Furthermore, the electricity generated by waste heat was consumed by affiliates and not included in income of the enterprise; the enterprise cannot enjoy the 10 percent revenue exclusion tax treatment.[24]

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[18] Article 34 of the CIT Law; Article 100 of the CIT Implementation Rules.

[19] Cai Shui [2008] No. 115.

[20] Cai Shui [2008] No. 118.

[21] Article 33 of the CIT Law; Article 99 of the CIT Implementation Rules.

[22] Cai Shui [2008] No. 117.

[23] Article 99 of the CIT Implementation Rules.

[24] Reply on Certain Issue of Corporate Income Tax Incentive for synergistic utilization of resources, Guo Shui Han [2009] No. 567, issued by the SAT on October 10, 2009.

8.4 Super Deduction of Research and Development Expenditures

The CIT Law allows an enterprise to claim additional deduction of research and development expenses incurred for development of new technologies, new products, and new technological processes.[25] Such additional tax deduction is 50 percent of the amount of qualified research and development expenses actually incurred where the research and development expenses are not required to be capitalized as intangible assets. Where the research and development expenses are required to be capitalized, the enterprise can amortize 150 percent of the capitalized research and development expenses.[26] The research and development activities qualified for the additional deduction are the continuous research and development activities toward definite objectives carried out by an enterprise for the purpose of procuring new knowledge of science and technology (excluding humanities and social sciences), using new scientific and technological knowledge in a creative manner or materially improving technologies, techniques, or products (services).[27] These activities are supposed to achieve valuable results that will advance the technology and process in the relevant industry in the region (province, autonomous region, municipality directly under the Central Government or city specifically designed in the state plan), and do not include conventional upgrading of enterprises' products (services) or direct application of open scientific research results and so on (such as direct adoption of open new technique, materials, equipments, products, services or knowledge, etc).[28]

Where an enterprise is engaged in the research and development on the subjects as listed in the High and New Technology Areas Supported by the State and the Guideline of the Latest Key Priority Developmental Areas in the High Technology Industry (2007) jointly issued by the National Development and Reform Commission and other departments, such enterprise may take the super 150 percent deduction for the following expenditures actually incurred:[29]

(1) The design expenses for new products, the expenditures for formulating new technical processes, and the expenses for technical books and materials and material translation directly relevant to the research and development activities;
(2) Expenses of materials, fuel, and electricity consumed in research and development activities;

[25] Article 30 of the CIT Law.

[26] Article 95 of the CIT Implementation Rules.

[27] Article 3 of the Measures for Administration of Corporate Income Tax Deduction of Research and Development Expenditures (for Trial Implementation), Guo Shui Fa [2008] No. 116, issued by the SAT on December 10, 2008 and effective on January 1, 2008.

[28] *Id.*

[29] Article 4 of Guo Shui Fa [2008] No. 116.

(3) The wages, salaries, bonuses, and allowances for the personnel who directly conduct the research and development activities;
(4) Depreciation expenses or lease expenses of equipment and facilities used especially for research and development activities;
(5) The amortization expenditures of intangible assets, such as software, patent and non-patented proprietary technologies used especially for research and development activities;
(6) Expenses of development and fabrication of moulds and equipment used specially for experiments;
(7) Site testing expenses for prospecting and exploitation technologies; and
(8) Expenses for argumentation, assessment and review, and acceptance inspection of research and development results.

For a qualified joint research and development project undertaken by more than one party, each party can take the super deduction for its share of actual expenses.[30] If an enterprise enters into a contract with another enterprise to undertake a qualified research and development project where the latter is paid for research and development services, the project owner may take a super deduction; the service provider cannot.[31] Where an enterprise does not have a separate research and development department or the research and development department of an enterprise is also engaged in production and operation simultaneously, the enterprise should separately account for research and development expenditures and production and operation expenditures, and accurately and reasonably compute each item of research and development expenditures. If the qualified research and development expenditures cannot be clearly separated, no super deduction is allowed.[32] If an enterprise engages several research development projects at the same time, the enterprise should separate account for the expenses of each project.[33] For computation of estimated tax, an enterprise can deduct the actual research and development costs; the additional deduction can be deducted on the enterprise's annual CIT return.[34]

8.5 Technology Transfer

The CIT Law provides tax incentives for transfer of technology. Within a tax year, an enterprise is exempted from CIT on the portion of income from technology transfer

[30] Article 5 of Guo Shui Fa [2008] No. 116.
[31] Article 6 of Guo Shui Fa [2008] No. 116.
[32] Article 9 of Guo Shui Fa [2008] No. 116.
[33] Article 10 of Guo Shui Fa [2008] No. 116.
[34] Article 12 of Guo Shui Fa [2008] No. 116.

that does not exceed RMB 5 million; the enterprise should be subject to CIT at a 50 percent reduction in CIT rate on the portion of income from technology transfer exceeding RMB 5 million.[35] To qualify for the tax incentives for a technology transfer, an enterprise must meet all of the following conditions:[36]

(1) The enterprise must be a resident enterprise;
(2) The technology transfer must be within the scope prescribed by the MOF and the SAT;
(3) Technology transfer within the territory of China must be confirmed by the governmental authority in charge of science and technology at the provincial level or above;
(4) Cross-border technology transfer from China must be confirmed by the bureau of commerce at provincial level or above;
(5) Technology transfer must satisfy other conditions that may be required by the relevant departments of the State Council.

Income from qualified technology transfer should be computed using the formula below:

$$\begin{aligned}&\text{Technology transfer income}\\&\quad = \text{Technology transfer revenue} - \text{Costs of technology transfer}\\&\qquad - \text{Relevant taxes and charges}\end{aligned}$$

Technology transfer revenue consists of the proceeds derived from performing technology transfer contract. Technology transfer revenue does not include the non-technical revenue such as the revenue from sales of equipment, instruments, parts, and materials. The revenue from technical consulting, technical services, and technical training that is not an inseparable part of the technology transfer project should not be included in technology transfer revenue. The costs of the technology transfer are the net value of intangible costs transferred, which is the balance of the tax basis of the intangible costs less the accumulated amortization calculated in accordance with tax law. The relevant taxes and charges are the actual taxes and charges incurred as a result of the technology transfer, including taxes other than the corporate income tax and creditable VAT, surcharges, contract signing fees, attorney fees, and other relevant expenses.[37] An enterprise

[35] Article 27(4) of the CIT Law; Article 90 of the CIT Implementation Rules.

[36] Article 1 of The Notice of Relevant Issues of Corporation Income Tax Exemption and Reduction in Relation to Technology Transfer, Guo Shui Han [2009] No. 212, issued by the SAT on April 24, 2009 and effective from January 1, 2008.

[37] Article 2 of Guo Shui Han [2009] No. 212.

that enjoys CIT exemption or reduction on technology transfer income should separately compute its technology transfer income and reasonably allocate the period expenses of the enterprise.[38]

An enterprise that makes a technology transfer should file with the tax authority in charge after the year-end but before the filing of annual CIT return for CIT exemption and reduction. For domestic technology transfer, the enterprise should submit a copy of the technology transfer contract, the technology contract registration issued by the science and technology authority at the provincial level or above, the documentation of technology transfer income, allocation, and computation, the evidence of actual tax and charges paid, and other documents required by the tax authorities. For the transfer of technology to a foreign country or region, an enterprise should submit a copy of the technology export contract, the technology export contract registration certificate, and the technology export permit issued by the department of commerce at the provincial level or above, the technology export contract data form, the documentation of technology transfer income, allocation, and computation, the evidence of actual tax and charges paid, and other documents required by the tax authorities. [39]

8.6 High and New Technology Enterprises

The CIT rate applicable to High and New Technology Enterprises eligible for key support from the State is reduced to 15 percent.[40] CIT Law and the CIT Implementation Rules authorize the departments of the State Council in charge of science and technology, finance and taxation to issue detailed guidance regarding the qualifications and certification procedures for High and New Technology Enterprises.[41] On April 14, 2008 and after receiving approval from the State Council, the Ministry of Science and Technology, the MOF and the SAT jointly issued the Administrative Measures for the Recognition of High and New Technology Enterprises and the Catalog of High and New Technology Areas Eligible for Key Support from the State (the "High-Tech Catalog").[42] On July 8, 2008, the Ministry of Science and Technology, the MOF and the SAT jointly issued the Administrative Working Guidelines of the Recognition of High and New Technology Enterprises (the "Working Guidelines"),[43] providing further guidelines for the application, review, and assessment of High and New Technology Enterprises.

[38] Article 3 of Guo Shui Han [2009] No. 212.

[39] Article 4 of Guo Shui Han [2009] No. 212.

[40] Article 28 of the CIT Law.

[41] Article 93 of the CIT Implementation Rules.

[42] Guo Ke Fa Huo [2008] No. 172.

[43] Issued as an attachment to Guo Ke Fa Huo [2008] No. 362.

8.6.1 QUALIFICATIONS

To be qualified as a High and New Technology Enterprise, an enterprise must meet all of the following requirements:

(1) An applicant must be a resident enterprise that has been established within the territory of the PRC, excluding Hong Kong, Macau and Taiwan, for not less than one year.[44]

(2) The enterprise must possess the proprietary intellectual property ("IP") rights of core technology used in its major products or services.[45] The core proprietary IP rights include inventions, utility models, and industrial designs in which the pattern and shape of a product is changed in a non-simple manner (which generally means designs as a result of the application of scientific and engineering technology in the course of research and development), software copyrights, proprietary rights to integrated circuit layout designs, and new varieties of plants.[46] The enterprise may obtain the core IP right within last three years through self-research and development activities, purchase, donation, merger, etc.[47] As an evidence of the ownership of core IP rights, the patents of inventions, utility models, and industrial designs should be registered under the enterprise's name with the State Intellectual Property Office; software copyrights should be registered under the enterprise's name with the National Copyright Administration of the PRC. As an alternative to the owning core IP rights, the enterprise may acquire an exclusive right to use the IP right for a period of at least five years.[48] During these five years, the licensee must have a worldwide exclusive right to use the licensed IP; anyone else including the licensor cannot use the IP.[49]

(3) The enterprise's products or services must fall within the scope of sectors listed in the High-Tech Catalog and its income from high-tech products or services must account for at least 60 percent of its total revenue.[50] The High-Tech Catalog lists more than 200 categories of technologies, products, and services in eight broad areas. Those areas include: (1) electronic information technology, (2) biological and pharmaceutical technology, (3) aviation and aerospace technology, (4) new materials technology, (5) high-tech services, (6) new energy

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[44] Article 2 of Guo Ke Fa Huo [2008] No. 172.

[45] Article 93 of the CIT Implementation Rules; Article 10 (1) of Guo Ke Fa Huo [2008] No. 172.

[46] Article 5 (1) of the Working Guidelines.

[47] Article 10 (1) of Guo Ke Fa Huo [2008] No. 172.

[48] Article 10 (1) of Guo Ke Fa Huo [2008] No. 172.

[49] Article 5 (1) of the Working Guidelines.

[50] Article 10 (2) and (5) of Guo Ke Fa Huo [2008] No. 172.

and energy conservation technology, (7) resources and environment technology, and (8) high-and-new technologies for traditional industries innovation. The enterprise's products or services must fall into one of those categories. High-tech products and service revenue also includes technical revenue, including revenue from technology transfer, revenue from technology contract, revenue from technical services, and revenue from contract R&D.[51]

(4) At least 30 percent of current workers and staff of the enterprise must have a college diploma; of those, research and development personnel must account for at least 10 percent of its total employees.[52] The research and development personnel is broadly defined, which includes R&D personnel, technical personnel, and support personnel. R&D personnel are specialists who primarily engage in R&D projects. Technical personnel are those who have knowledge and experience in engineering, nature science, or life science and work under the supervision of R&D personnel in collecting information, writing computer programs, conducting experience, tests and analysis, preparing materials and equipment for experience, tests and analysis, recording data, preparing chart and schedules, collecting statistics, etc. Support personnel are skilled workers participating in R&D activities. A person can be counted as R&D personnel if she or he works in the above areas in aggregate for more than 183 days in a year.[53]

(5) The research and development expenses of the enterprise must, as a percentage of revenue over the most recent three fiscal years (or over the enterprise's entire operating history if shorter), exceed the following sliding scale:

Total revenue in preceding year	Minimum R&D expenses as percent of revenue
below RMB 50 million	6%
RMB 50 million - 200 million	4%
above RMB 200 million	3%

At least 60 percent of an entity's R&D expenditures must be made within the PRC.[54] The R&D activities are the continuous research and development activities toward definite objectives carried out by an enterprise for the purpose of procuring new knowledge of science and technology (excluding humanities and social sciences), using new scientific and technological knowledge in a creative manner or materially improving

[51] Article 5 (3) of the Working Guidelines.

[52] Article 10 (3) of Guo Ke Fa Huo [2008] No. 172.

[53] Article 5 (2) of the Working Guidelines.

[54] Article 10 (4) of Guo Ke Fa Huo [2008] No. 172.

technologies, technique or products (services).[55] The R&D expenses include salaries and other compensation of R&D personnel, direct expenses such as materials, tools, repair fees, fixed assets leasing, depreciation of equipment, design fees, equipment testing, amortization of intangibles, and contract R&D expenses. The R&D expenses can also include office expenses, communication expenses, patent maintenance expenses, and insurance expenses in relation to R&D activities; those expenses, however, generally should not exceed 10 percent of total R&D expenditure[56]

(1) The enterprise must score 70 or higher on a 100-point administrative evaluation. In addition to the requirements listed in items 1 to 5 above, the approval authorities use a scorecard system in order to assess whether an entity qualifies for the High and New Technology Enterprise status. An applicant must receive 70 or more points out of 100. The score card appears as follows:[57]

Category	Points
IP Rights	30
Capacity to Convert Science and Technology.	30
R&D Management Practices	20
Maintenance of Asset and Revenue Growth Rates	20
Total	100

There are six classes in each category. The ranges of score assigned to the six classes are as follows:

A: 0.80–1.0
B: 0.60–0.79
C: 0.40–0.59
D: 0.20–0.39
E: 0.01–0.19
F: 0

An enterprise will be assessed as A, B, C, D, E, or F in each category. A score in a category is the full point in that category times the score assigned within the range of score. The sum of scores in all four categories is the total points for the enterprise.[58]

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[55] Article 4 (1) of the Working Guidelines.
[56] Article 4 (2) of the Working Guidelines.
[57] Article 6 of the Working Guidelines.
[58] Article 6 (1) of the Working Guidelines.

(i) *IP rights*

The classification of an enterprise in the IP rights category is based on the number of patents, software copyrights, proprietary rights to integrated circuit layout designs, and new plant varieties (excluding trademark) owned by the enterprise. The enterprise should be classified as "A" if it owns at least one invention patent or at least six other IP items. An enterprise that owns no invention patent but owns 5, 4, 3, 1–2, or 0 other IP items should be classified as B, C, D, E, or F, respectively.[59] As such, the ownership of one invention patent may be enough to receive the maximum amount of points in the category. An enterprise's score in IP right category will be computed as follows:

Class A: between 24 points (0.8 x 30) and 30 points (1.0 x 30)
Class B: between 18 points (0.6 x 30) and 23.7 points (0.79 x 30)
Class C: between 12 points (0.4 x 30) and 17.7 points (0.59 x 30)
Class D: between 6 points (0.2 x 30) and 11.7 points (0.39 x 30)
Class E: between 0.3 points (0.01 x 30) and 5.7 points (0.19 x 30)
Class F: 0 points (0 x 30)

(ii) *Capacity to convert science and technology*

An entity should have a proven capacity to convert R&D into products and services. In the "Capacity to Convert Science and Technology" category, points are assigned based on the number of converted R&D projects within the last three years prior to the submission of an application. For example, using one patent to produce products, services, or a product sample will be counted as one successful conversion. The number of projects required for classification[60] and points assigned based on such classification in this category as follows:

Class	No. of projects required	Score points
A	more than 4	24–30
B	3–4 (excluding 3)	18–23.7
C	2–3 (excluding 2)	12–17.7
D	1–2 (excluding 2)	6–11.7
E	1	0.3–5.7
F	0	0

[59] Article 6 (2)(1) of the Working Guidelines.

[60] Article 6 (2)(2) of the Working Guidelines.

(iii) *R&D management practices*

An entity must utilize certain R&D management practices in order to earn points in the "R&D Management Practices" category. There are five practices that will earn entity points: establishing an R&D-specific accounting system; combining R&D and production; establishing an R&D branch with facilities; formulating a project initiation report; and implementing a performance-based reward system for R&D personnel. The classification of an enterprise in this category will be based on the number of practices that satisfied the requirement.[61] As a full score is 20 in this category, an enterprise's score will be computed as follows:

Class	No. of qualified practices	Score points
A	5	16–20
B	4	12–15.8
C	3	8–11.8
D	2	4–7.8
E	1	0.2–3.8
F	0	0

(iv) *Maintenance of asset and revenue growth rates*

An enterprise must maintain minimum asset and revenue growth rates in order to earn points in the "Maintenance of Asset and Revenue Growth Rate" category. Asset growth and revenue growth are separately computed based on the preceding three year's audited financial statements. For example, if an enterprise applies for the High and New Technology Enterprise status in Year 4 (Y4), the asset growth rate and revenue growth rates will be calculated as follows:

$$\text{Asset growth rate} = \tfrac{1}{2} \times (\text{Total assets for Y2} \div \text{Total assets for Y1} + \text{Total assets of Y3} \div \text{Total assets of Y2}) - 1$$

$$\text{Revenue growth rate} = \tfrac{1}{2} \times (\text{Sales for Y2} \div \text{Sales for Y1} + \text{Sales for Y3} \div \text{Sales for Y2}) - 1$$

[61] Article 6 (2)(3) of the Working Guidelines.

The maximum score for each growth rate is 10 points. The classification of an enterprise in this category with respect to each growth rate will be based on its respective growth rate. [62] The class and score assignment for each growth rate are as follows:

Class	Growth rate	Score points
A	0.35 or higher	8–10
B	0.25 or more but less than 0.35	6–7.9
C	0.15 or more but less than 0.25	4–5.9
D	0.05 or more but less than 0.15	2–3.9
E	Less than 0.05	0.1–1.9

For example, if an enterprise has asset growth rate of 35 percent and revenue growth rate of 25 percent, the enterprise will be in class A in asset growth rate and class B in revenue growth rate; its score in the category of Maintenance of Asset and Revenue Growth Rates will be:

Score in asset growth rate: between 8 points and 10 points
Score in revenue growth rate: between 6 points and 7.9 points
Total score: between 14 points and 17.9 points

8.6.2 APPLICATION PROCEDURES

According to the Working Guidelines, the government departments in charge of science and technology, finance, and taxation in each autonomous region, municipality directly under the Central Government, and city specifically designated in the state plan will jointly form an office in charge of examination and approval of applications for High and New Technology Enterprises with its jurisdiction.[63] In practice, an application may actually be submitted to a joint office set up at a lower level, such as a district of a municipality. The application is involved in several steps:

(1) Self-assessment. An applicant should conduct a self-assessment in accordance with the qualification criteria.[64]
(2) Registration. If an enterprise believes that it meets all the qualifications for a High and New Technology Enterprise through the self-assessment, it should

[62] Article 6 (2)(4) of the Working Guidelines.
[63] Article 1 of the Working Guidelines.
[64] Article 11(1) of Guo Ke Fa Huo [2008] No. 172; Article 2(1)(1) of the Working Guidelines.

register at an official website and submit an enterprise registration form to the approval office via the Web site www.innocom.gov.cn.[65]

(3) Preparation and submission of application. An enterprise should prepare and submit required application documents and supporting information to the approval authority, including:[66]

  (i) Application Form for High and New Technology Enterprise Certification;
  (ii) Copies of Business License and Tax Registration Certificate;
  (iii) A special audit report on research and development expenses incurred in the most recent three fiscal years (or over the enterprise's entire operating history if shorter) prior to the year in which the application is submitted and the income derived from high-tech products (services) in the previous fiscal year, as certified by a qualified CPA firm meeting the conditions specified in the Working Guidelines;
  (iv) Financial statements (including balance sheet, profit and loss statement, and cash flow statement) for the three previous fiscal years (or the actual number of years if the enterprise has shorter history), as certified by a qualified CPA firm; and
  (v) Technological innovation certificates, including IP certificates, exclusive licensing agreements, production approval documents, new product or new technology certificates, quality inspection reports, certificates for scientific and technological projects at or above the provincial level (including cities specifically designated in the state plan) and other relevant certificates.

(2) Review and assessment. For the purpose of assessing technological qualification of High and New Technology Enterprise applicants, the approval authority at each province is required to set up an expert pool including in experts in the fields listed in the High-Tech Catalog. After receiving an enterprise's application documents, the approval authority should randomly select five experts in the relevant technological field from the expert pool. The experts will review electronic documents without the identity information of the applicant, and will deliver their opinions. The responsibilities of the experts are (1) to review whether the R&D projects submitted by the applicant satisfy the requirements as provided in the Administrative Measures for the Recognition of High and New Technology Enterprises and the Working Guidelines; (2) to assess qualifications of the R&D activities, core IP rights, and main business

[65] Article 11(1) of Guo Ke Fa Huo [2008] No. 172; Article 2(1)(2) of the Working Guidelines.

[66] Article 11(2) of Guo Ke Fa Huo [2008] No. 172; Article 2(1)(3) of the Working Guidelines.

of the enterprise; and (3) to complete a comprehensive assessment report and serve as consultants to the approval authority. The approval authority will consider the experts' opinions and the special audit report from the CPA firm, and determine whether the application is qualified to be listed as a pre-certified High and New Technology Enterprise. The review and assessment should be completed within sixty days of receiving the enterprise's application documents.[67]

(3) Notice and certification. Once an enterprise is initially recognized as a High and New Technology Enterprise after steps 1–4 above, the approval authority will publish the name of the enterprise on Web site www.innocom.gov.cn for a period of 15 days for public comments. If any objection is made, the approval authority should investigate the allegation; if the allegation to disqualify the High and New Technology Enterprise status of an enterprise is verified, the approval authority should revoke the enterprise's status. In the absence of any objection, the approval authority will fill out a summary form with an office of the leadership group that supervises the activities of the approval authority; will publish, on www.innocom.gov.cn, the final determination of High and New Technology Enterprise status of the applicant; and will then issue a High and New Technology Enterprise Certificate to the enterprise.[68]

The certificate will be valid for a period of three years from the issuance date. To continue High and New Technology Enterprise status, an enterprise must apply for reexamination and recertification three months prior to the expiration date of current certificate. Without proper recertification, the enterprise will automatically lose its High and New Technology Enterprise status.[69]

8.6.3 APPLICATION FOR TAX INCENTIVES

Once an enterprise is certified as a High and New Technology Enterprise, it may apply for the tax incentives under the CIT Law and regulations, including the reduced 15 percent CIT rate. However, the High and New Technology Enterprise certification does not guarantee the enterprise three years of tax benefits. The enterprise must continue to meet the qualification requirements each year during the period of validity of the certificate. In particular, the revenue of the enterprise from its high-tech products and services cannot be lower than 60 percent of its total business revenue each year.

[67] Article 11(3) of Guo Ke Fa Huo [2008] No. 172; Article 2(1)(4) and Article 3(2) of the Working Guidelines.

[68] Article 11(4) of Guo Ke Fa Huo [2008] No. 172; Article 2(1)(5) of the Working Guidelines.

[69] Article 12 of Guo Ke Fa Huo [2008] No. 172.

8.7 Software and Integrated Circuits

The MOF and the SAT provide certain CIT incentives that are approved by the State Council and which promote the development of software and integrated circuit industry in China. There are two groups of CIT incentives; one group is applicable to software enterprises and integrated circuit design enterprises and another group to integrated circuit production enterprises and their investors.

Software enterprises and integrated circuit design enterprises are eligible for the following CIT incentives:

(1) CIT exemption on VAT refund. Software enterprises generally are subject to VAT at a regular rate of 17 percent. To encourage the development of software industry, a resident software enterprise that is registered as a general VAT payer can receive a VAT refund for the portion of VAT payable exceeding 3 percent for the sales of domestic developed software in China for the period from June 24, 2000 to December 31, 2010. The same VAT refund also applies to integrated circuit enterprises.[70] Such a VAT refund is exempt from CIT if the fund is used by the enterprise for software R&D and the expansion of production.[71]

(2) Tax holiday. Newly established software enterprises or newly established integrated design enterprises are entitled to a two-year CIT exemption and a three-year 50 percent reduction in CIT rate from the first profit-making year.[72]

(3) Low tax rate. Key software/integrated circuit design enterprises included in the State plan, if not otherwise eligible for CIT exemption that year, can enjoy a reduced CIT rate of 10 percent.[73]

(4) Training expense deduction. The deduction of staff education expenses by an enterprise for CIT purposes is limited to 2.5 percent of the enterprise's total salaries. Software enterprises and integrated circuit design enterprises can deduct employee training expenses actually incurred without this limitation.[74]

[70] Notice of Tax Policies for Encouraging the Development of the Software and the Integrate Circuit Industries, Cai Shui [2000] No. 25, issued by the MOF, the SAT, and the General Administration of Customs on September 12, 2000.

[71] Article 1(1) and (6) of Cai Shui [2008] No. 1.

[72] Article 1(2) and (6) of Cai Shui [2008] No. 1.

[73] Article 1(3) and (6) of Cai Shui [2008] No. 1.

[74] Article 1(4) and (6) of Cai Shui [2008] No. 1.

Integrated circuit production enterprises and their investors are eligible for the following CIT incentives:

(1) An integrated circuit production enterprise with a total investment exceeding RMB8 billion or whose integrated circuit width of less than 0.25um can be granted for a reduced CIT rate of 15 percent. If such an enterprise has an operating period of no less than 15 years, the enterprise can be granted for a five-year CIT exemption and a five-year 50 percent CIT rate reduction from the first profit-making year.[75]
(2) An integrated circuit production enterprise whose circuits are less than 0.8um can be granted for a two-year CIT exemption and a three-year 50 percent CIT rate reduction from the first profit-making year.[76]
(3) If an investor of integrated circuit production enterprise or integrated circuit packaging enterprise reinvests after-tax profits in 1) the same enterprise by increasing registered capital or 2) other integrated circuit production or integrated circuit packaging enterprises by establishing new enterprises and the reinvestment period is not less than five years, the investor will be entitled to a refund of 40 percent of CIT paid in connection with the reinvested profits. If the investor is an economic organization and uses the after-tax profits from domestic enterprises as capital to establish integrated circuit production enterprises, integrated circuit packaging enterprises, or software production enterprises in Western Regions with a reinvestment period of not less than five years, the investor can receive 80 percent of CIT paid in connection with the reinvested profits. The reinvestment CIT refund policy applies for the period from January 1, 2008 to December 31, 2010.[77]

8.8 Animation Enterprises

China encourages the development of animation industry. In April 2006, the General Office of the State Council forwarded the Opinions of the MOF, the Ministry of Education, the Ministry of Science and Technology, the Ministry of Information Industry, the Ministry of Commerce, the Ministry of Culture, the SAT, the State Administration for Industry and Commerce, the State Administration of Radio, Film and Television and the General Administration of Press and Publication on Promoting

[75] Article 1(8) of Cai Shui [2008] No. 1.
[76] Article 1(9) of Cai Shui [2008] No. 1.
[77] Article 1(10) of Cai Shui [2008] No. 1.

the Development of China's Animation Industry.[78] The policy document requests that the MOF and the SAT formulate CIT incentive policies to support the development of animation industry. In July 2009, the MOF and the SAT issued a circular, which provides that the recognized animation enterprises that self-develop and produce animation products may apply for the CIT incentives that currently available for software enterprises.[79] For specific tax incentives, please see Chapter 8.7.

For the purposes of qualifying for tax incentives, animation enterprises include cartoon design enterprises, animation design and production enterprises, Internet animation (including mobile animation), design and production enterprises, animation drama and program production or performing enterprises, animation software development enterprises, and animation derivative products development and design enterprises.[80] The animation products eligible for tax incentives include various kinds of cartoons (frames, illustration art, books, newspapers and magazines, etc.), animations (animated films, TV series, video products, animations shown in various TV programs), the cartoon and animation products transmitted through the Internet and mobile networks and terminals such as computers and mobile phones, animation dramas and programs, animation software (animation graphic design, special software for animation production, audio and video production tools software, etc.), and animation derivative products (costumes, toys, stationery, computer games, etc. related to animation).[81]

A recognized animation enterprise must meet all of the following requirements:[82]

(1) The applicant must be an enterprise legally established in China;
(2) The revenue derived from animation products of main business revenue must be at least 60 percent of total annual revenue of the enterprise;
(3) The revenue derived from self-developed and produced animation products must be at least 50 percent of its main business revenue. The self-developed and produced animation products are the animation products (excluding animation derivative products) designed, developed, produced, or performed by the

[78] The Notice on Forwarding the Several Opinions of the Ministry of Finance, the Ministry of Education, the Ministry of Science and Technology, the Ministry of Information Industry, the Ministry of Commerce, the Ministry of Culture, the State Administration of Taxation, the State Administration for Industry and Commerce, the State Administration of Radio, Film and Television and the General Administration of Press and Publication on Promoting the Development of China's Animation Industry, Guo Ban Fa [2006] No. 32, issued by the General Office of the State Council on April 25, 2006.

[79] Article 2 of the Notice on Tax Policies Concerning Supporting the Development of Animation Industry, Cai Shui [2009] No. 65, issued by the MOF and the SAT on July 17, 2009 and effective on January 1, 2009.

[80] Article 4 of Administrative Measures for Recognition of Animation Enterprises (Trial implementation), Wen Shi Fa [2008] No. 51, issued by the Ministry of Culture, the MOF and the SAT on December 18, 2008 and effective on January 1, 2009.

[81] Article 5 of Wen Shi Fa [2008] No. 51.

[82] Article 10 of Wen Shi Fa [2008] No. 51.

enterprise. The self-developed and produced animation products do not include simple outsourcing services for overseas creation, simple imitation, or simple productions for overseas for which the enterprise does not have IP rights, nor for which it is competitive;[83]

(4) The professional or technical personnel who have a college diploma or a State animation professional certificate must be at least 30 percent of the current total employees; of those, R&D personnel must be at least 10 percent of current total employees;

(5) The enterprise must have the necessary equipment and facilities for animation product development or related services;

(6) The animation product research and development expenses must be at least 8 percent of the total current year business revenue;

(7) The contents of animation products are positive and healthy and do not include those prohibited by laws; and

(8) The ownership of enterprise is clear; the enterprise is well-managed and complies with law.

The Ministry of Culture, the MOF, and the SAT set up a national office in charge of administration of animation enterprises.[84] The government departments in charge of culture, finance, and taxation in each autonomous region, municipality directly under the Central Government and city specifically designated in the state plan will jointly form an office in charge of initial examination of applications for animation enterprises.[85] If an enterprise plans to apply for animation enterprise, it should conduct a self-assessment. If the enterprise believes that it qualifies for animation enterprise, it can submit application to the office at provincial level. After an initial review and approval of the provincial office, the provincial office will forward the application to the national office. The Ministry of Culture, the MOF and the SAT will jointly issue lists of recognized animation enterprises; the provincial office will issue animation enterprise certificates to those on the national lists.[86]

8.9 Venture Capital Investment Enterprises

If a venture capital enterprise has invested, in the form of equity investment, in a medium- to small-sized High and New Technology Enterprise that has not been listed on a stock exchange for more than two years, 70 percent of the amount so invested may

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[83] Article 11 of Wen Shi Fa [2008] No. 51.

[84] Article 6 of Wen Shi Fa [2008] No. 51.

[85] Article 7 of Wen Shi Fa [2008] No. 51.

[86] Article 14 of Wen Shi Fa [2008] No. 51.

be set off against the taxable income of the venture capital enterprise; the excess amount can be carried forward.[87]

Venture capital enterprises that may be eligible for tax incentives are the enterprises or other economic organizations established in accordance with the Provisional Measures for the Administration of Venture Capital Investment Enterprises[88] and the Administrative Measures for Foreign Invested Venture Capital Investment Enterprises.[89] The medium- to small-sized High and New Technology Enterprises must be those that have been certified as High and New Technology Enterprises in accordance with Administrative Measures for the Recognition of High and New Technology Enterprises and the Administrative Working Guidelines of the Recognition of High and New Technology Enterprises.[90] Additionally, the High and New Technology Enterprise must have no more than five hundred employees, annual sales of not more than RMB 200 million, and total assets of not more than RMB 200 million.[91] The two-year investing period starts from the year in which the investee is certified as a High and New Technology Enterprise after the investment of venture capital. If, during the two-year period, the investee exceeds the medium- to small-sized standard, it will not disqualify the eligibility of the venture capital enterprise for the CIT incentive as long as the investee remains as a High and New Technology Enterprise.[92] If an investee enterprise had obtained the medium- to small-sized High and New Technology Enterprise status on or before December 31, 2007 and continued to satisfy the qualification requirement of High and New Technology Enterprise in 2008, the venture capital investment enterprise can count its 24-month investment period from its actual investment date in the investee.[93]

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[87] Article 31 of the CIT Law; Article 97 of the CIT Implementation Rules.

[88] Provisional Measures for the Administration of Venture Capital Investment Enterprises, Order of NDRC [2005] No. 39, approved by the State Council on September 7, 2005, and jointly issued by the National Development and Reform Commission, the Ministry of Science and Technology, the MOF, the Ministry of Commerce, the People's Bank of China, the SAT, the State Administration for Industry and Commerce, the China Banking Regulatory Commission, the China Securities Regulatory Commission and the State Administration of Foreign Exchange, and effective on March 1, 2006.

[89] Administrative Measures for Foreign Invested Venture Capital Investment Enterprises, Order of the Ministry of Foreign Trade and Economic Cooperation, the Ministry of Science and Technology, the State Administration for Industry and Commerce, the SAT and the State Administration of Foreign Exchange [2003] No. 2, issued by the Ministry of Foreign Trade and Economic Cooperation, the Ministry of Science and Technology, the State Administration for Industry and Commerce, the SAT and the State Administration of Foreign Exchange on January 30, 2003 and effective on March 1, 2003.

[90] Guo Ke Fa Huo [2008] No. 362.

[91] Article 2 of the Notice on Issues Concerning the Implementation of Corporate Income Tax Incentives for Venture Capital Investment Enterprises, Guo Shui Fa [2009] No. 87, issued by the SAT on April 30, 2009 and effective on January 1, 2008.

[92] Article 3 of Guo Shui Fa [2009] No. 87.

[93] Article 2 of Guo Shui Fa [2009] No. 87.

In order to enjoy the offset of the investment amount against its taxable income, a venture capital investment enterprise must file the following documents with the tax authority in charge before it files its annual CIT return:[94]

(1) The certification paper for completion of annual inspection of the venture capital investment enterprise;
(2) An explanation of investment operations of the venture capital investment enterprise;
(3) A copy of investment contract with or Articles of Association of the medium- to small-sized High and New Technology Enterprise and capital verification report on the actual investment made by the venture capital investment enterprise;
(4) Basic information of the medium- to small-sized High and New Technology Enterprise, including number of employees, annual revenue, total assets, etc.; and
(5) A copy of the Certificate of High and New Technology Enterprise issued to the investee enterprise.

8.10 Clean Development Mechanism Projects

China is a party to the United Nations Framework Convention on Climate Change and its Kyoto Protocol. The Clean Development Mechanism (CDM) is an arrangement under the Kyoto Protocol allowing developed countries with a greenhouse gas reduction commitment to invest in projects that reduce emissions in developing countries as an alternative to more expensive emission reductions in their own countries. Under this arrangement, participants in developed countries can acquire certified emission reductions (CERs) generated by the projects implemented in developing countries. The CDM is intended to reduce net global greenhouse gas emissions at a lower global cost. China enterprises that implement CDM projects can sell CERs to the participants in developed countries. Only domestic enterprises and the Chinese-foreign joint venture companies with Chinese majority ownership can participate in CDM projects.[95] The revenue derived from the transfer of CERs is shared between the participating enterprises and the State. Share ratios depend on the types of projects.

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[94] Article 4 of Guo Shui Fa [2009] No. 87.

[95] Article 11 of Measures of the Operations of Clean Development Mechanism Projects, Order of NDRC, the Ministry of Science and Technology, the Ministry of Foreign Affairs, and the MOF [2005] No. 37, issued by National Development and Reform Commission, the Ministry of Science and Technology, the Ministry of Foreign Affairs, and the MOF on October 12, 2005 and effective on October 12, 2005.

Projects	Revenue share of the State
Reduce greenhouse emissions of hydrofluorocarbon (HFC) and perfluorocarbon (PFC)	65%
Reduce greenhouse emissions of nitrous oxide (N_2O)	30%
Energy efficiency improvement, development and utilization of new and renewable energy, and methane recovery and utilization	2%

The above revenue retained by the State from CDM projects will be contributed to China CDM Fund and will be used to support climate change activities.[96]

The revenue received by China CDM Fund is exempt from CIT.[97] Participating enterprises can deduct the portion of revenue, based on the above revenue sharing ratio, paid to the State for CIT purposes.[98] For a CDM project where 65 percent of CER transfer revenue is retained by the State (e.g., a project to reduce the emission of HFC and PFC) or where 30 percent of CER transfer revenue is retained by the State (e.g., on a project to reduce the emission of N_2O), the participating enterprise is exempted on the income derived from the implementation of a CDM project for three years from the initial revenue generated from the CER transfer, and can enjoy a 50 percent reduction in CIT rate from the fourth to the sixth year. The income from the implementation of a CDM project is the revenue derived from the CER transfer less the portion of revenue paid to the State and the costs and expenses of implementing the CDM project. An enterprise is required to separately account for income from CDM projects and reasonably allocate relevant period expenses. An enterprise cannot enjoy the tax incentives without such separate accounting.[99]

8.11 Service Outsourcing Business

In the efforts to develop service outsourcing industry in China, the State Council has listed 21 cities, including Beijing, Changsha, Chengdu, Chongqing, Dalian, Daqing, Guangzhou, Hangzhou, Harbin, Hefei, Ji'nan, Nanchang, Nanjing, Tianjin, Shanghai, Shenzhen, Suzhou, Wuhan, Xiamen, Xi'an, and Wuxi, as the model cities of outsourcing industry to undertake international service outsourcing businesses.[100] Various financial and tax incentives are provided to qualified outsourcing service enterprises.

[96] Article 24 of Order of NDRC, the Ministry of Science and Technology, the Ministry of Foreign Affairs, and the MOF [2005] No. 37.

[97] Article 1 of the Notice on Corporate Income Tax Polices for China CDM Fund and CDM Projects, Cai Shui [2009] No. 30, issued by the MOF and the SAT on March 23, 2009 and effective on January 1, 2007.

[98] Article 2(1) of Cai Shui [2009] No. 30.

[99] Article 2(2) of Cai Shui [2009] No. 30.

[100] Article 1 of the Reply on Issue Concerning Promoting the Development of Service Outsourcing Industry, Guo Ban Han [2009] No. 9, issued by the General Office of the State Council on January 15, 2009. Twenty cities

If an enterprise is recognized as an Advanced Technology Service Enterprise, it can enjoy a reduced CIT rate of 15 percent; the enterprise may deduct employee education expenses that have actually been incurred by the enterprise for up to 8 percent of total salaries. The portion of such expenses in excess of the eight percent limitation can be carried forward to future years.[101]

8.11.1 SCOPE OF ADVANCED TECHNOLOGY SERVICES

To be recognized as an Advanced Technology Service Enterprise, the enterprise must engage in one or more types of services as listed below:

(1) Information technology outsourcing (ITO). ITO includes services listed in the table below:

Type of ITO	Service	Scope
Software R&D outsourcing	Software R&D services	Software development for the operations, production, supply chain, client relationship, human resource management, financial management, computer-aided design/engineering of users in the fields of finance, government, education, manufacturing, retail, service, energy, logistics, transportation, media, telecommunications, public utility and medical and health, including customized software development, embedded software, packaged software development, system software development, and software testing
	Software technical services	Technical services, such as software consulting, maintenance, training, and testing

(*Continued*)

were selected in first batch. In February 2010, Xiamen was added to the list by the State Council.

[101] Article 1 of the Notice on Tax Policies Concerning Advanced Technology Service Enterprises, Cai Shui [2009] No. 63, issued by the MOF, the National Development and Reform Commission, the SAT, the Ministry of Science and Technology, and the Ministry of Commerce on April 24, 2009 and effective from January 1, 2009 to June 30, 2010; Article 1 of the Notice on Corporate Income Tax Policies Concerning Advanced Technology Service Enterprises, Cai Shui [2010] No. 65, issued by the MOF, the SAT, the Ministry of Commerce, the Ministry of Science and Technology, and the National Development and Reform Commission on November 5, 2010 and effective from July 1, 2010 to December 31, 2013.

Type of ITO	Service	Scope
Information technology R&D outsourcing	Integrated circuit and electronic circuit design	Design of integrated circuit and electronic circuit products and related technical and supporting services
	Test platform	Provision of test platform for the development and application of software, integrated circuit and electronic circuit
Information system operation and management outsourcing	Operation and maintenance service of information system	Information system application services such as integration of clients' internal information system, network management, desktop management and maintenance services; information engineering, geographic information system, and remote maintenance
	IT infrastructural services	IT infrastructural services, such as integration of management platform of IT infrastructural services, IT infrastructure management, data center, hosting center, security service, and communication services

(2) Business process outsourcing (BPO). BPO includes services listed in the table below:

Service	Scope
Business process design services	Provision of internal management and business operation process design services for clients
Enterprise internal management services	Provision of services of data analysis, data mining, data management and data application for back-office management, HR management, finance, audit and taxation management, financial payment service, medical information, and other internal management of clients business; undertaking of professional data processing, analysis, and integration services

(*Continued*)

Service	Scope
Enterprise operation services	Provision of services such as technology R&D services, application of customer analysis, database management for the operation, sales, and after-sale services; all of which are provided mainly to the following sectors: financial services, government and education, manufacturing and life science, retail and wholesale and transportation, health care, communication and public utility, call center, and e-commerce platform.
Enterprise supply chain management services	Overall scheme design and database service for the purchase and logistics business of the clients

(3) Knowledge process outsourcing (KPO). The scope of KPO includes intellectual property right research, R&D and testing of pharmaceuticals and biotechnology, product and technology R&D, industrial design, analytics and data mining, design and R&D of animated cartoon and online games, and R&D of educational courseware, engineering design.

8.11.2 QUALIFICATION FOR ADVANCED TECHNOLOGY SERVICE ENTERPRISES

An Advanced Technology Service Enterprise must meet all of the following conditions:[102]

(1) The enterprise must engage in one or more types of services within the scope discussed in Chapter 8.11.1 and must have adopted advanced technology or have strong R&D capabilities.
(2) The registered address and place of operation of the enterprise must be in one of the 21 pilot service outsourcing cities (inclusive of all administrative divisions such as districts, counties, and county-level cities);
(3) The enterprise must be a legal person and have no violation of law in the areas of import and export, finance, taxation, foreign exchange, and customs within the last two years;
(4) More than 50 percent of employees of the enterprise must have a college diploma;

[102] Article 2 of Cai Shui [2010] No. 65.

(5) More than 50 percent[103] of income of the enterprise must be derived from the advanced technology services as listed in (1); and

(6) The enterprise must have entered into outsourcing contracts with overseas clients, and its income from offshore outsourcing services provided to overseas clients should not be less than 50 percent of its total income of the year.

8.11.3 PROCEDURES FOR RECOGNITION OF ADVANCED TECHNOLOGY SERVICE ENTERPRISES

The departments in charge of science and technology in the model service outsourcing cities should formulate specific administrative measures with departments of commerce, finance, tax, and development and reform at the same level in accordance with the national regulations, and report the same to the Ministry of Science and Technology, the MOF, the SAT, the Ministry of Commerce and the National Development and Reform Commission. An enterprise should submit an application for Advanced Technology Service Enterprise with the department in charge of science and technology in its city. The department in charge of science and technology should make a joint review of the application with the departments in charge of commerce, finance, tax, and development and reform at the same level Those government departments jointly issue a certification document to qualified enterprises. Lists of recognized Advanced Technology Service Enterprises shall be filed with the Ministry of Science and Technology, the Ministry of Finance, the State Administration of Taxation, the Ministry of Commerce and the National Development and Reform Commission and, at the same time, with those authorities at provincial level.[104]

8.12 Employment of Disabled Personnel

An enterprise that employs disabled personnel may take additional CIT deduction equal to 100 percent of the amount of the actual salary paid to the disabled employees (i.e., a total of a 200 percent deduction).[105] The disabled personnel for this purpose are

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[103] At least 70 percent was provided in Cai Shui [2009] No. 63. This percentage was reduced to 50 percent by the State Council in Article 1 of the Reply on Accelerating the Development of Service Outsourcing Industry, Guo Ban Han [2010] No. 69, issued by the General Office of the State Council on April 7, 2010. Cai Shui [2009] No. 63 also requires that an Advanced Technology Service Enterprise has obtained relevant international qualifications certification. This certification requirement was eliminated by the State Council in Guo Ban Han [2010] No. 69.

[104] Article 3 of Cai Shui [2010] No. 65.

[105] Article 32(2) of the CIT Law; Article 96 of the CIT Implementation Rules.

determined in accordance with the Law of the PRC on Safeguard of Disabled Persons, which defines a disabled person as one who suffers from abnormalities or loss of a certain organ or function, psychologically or physiologically, or in anatomical structure, and has lost in whole or in part the ability to perform an activity in the way considered normal, including those with visual, hearing, speech or physical disabilities, mental retardation, mental disorder, multiple disabilities, and/or other disabilities.[106]

To qualify for additional deduction for salaries paid to disabled employees, an enterprise must satisfy all of the following conditions:[107]

(1) The enterprise must sign an employment contract or service contract with each disabled person for a term of one year or more, and must place each disabled person in an actual work position within the enterprise;
(2) The enterprise must make sufficient social security contributions such as basic pension, basic medical insurance, unemployment insurance, and worker's injury insurance on behalf of each disabled employee in accordance with the relevant regulations of county or district government;
(3) The enterprise must regularly make salary payments to each disabled employee through bank transfers; the salary shall not be less than the minimum wage prescribed by the county or district government where the enterprise is located; and
(4) The enterprise must have basic facilities for placing disabled persons to work.

A qualified enterprise that employs disabled persons can deduct actual salaries paid to the disabled persons when making estimated CIT payments. The enterprise can make additional 100 percent salary deduction on its annual CIT return.[108] When the enterprise makes its annual CIT filing, it should file with the tax authority in charge a name list of disabled employees, the copies of Certificates of Disabled Persons of the PRC or Certificates of Disabled Military Persons of the PRC of those employees, and other materials requested by the tax authority.[109]

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[106] Article 96 of the CIT Implementation Rules; Article 2 of the Law of the PRC on Safeguard of Disabled Persons, adopted by the Standing Committee of the NPC on December 28, 1990, and amended by the Standing Committee of the NPC on April 24, 2008.

[107] Article 3 of the Notice on Policies Concerning Corporate Income Tax Incentives for Employment of Disabled Persons, Cai Shui [2009] No. 70, issued by the MOF and the SAT on April 30, 2009 and effective on January 1, 2008.

[108] Article 1 of Cai Shui [2009] No. 70.

[109] Article 4 of Cai Shui [2009] No. 70.

8.13 Culture Enterprises

Many organizations engaged in business operations in journalism, publishing, broadcasting, film, television, culture, and art are publicly funded institutions. The State encourages a reform of the culture industry and converts those institutions into business enterprises. Those culture enterprises converted from publicly-funded institutions are exempted from CIT from the date of business registration until December 31, 2013. The conversion includes an incorporation of the entire business of a publicly-funded institution or a spin-off of a partial business of a publicly-funded institution.[110]

If a culture enterprise in the category encouraged by government was established between January 1, 2004 and December 31, 2008, the enterprise will be exempted from CIT for up to three years commencing on the date of business registration of the enterprise, provided, however, the tax holiday period will end on December 31, 2010.[111] Those culture enterprises encouraged by the government include:[112]

(1) Art performance groups;
(2) Culture, arts, and performance brokers;
(3) Enterprises engaged in press, publication, broadcasting, film, television, culture and art exhibition;
(4) Theaters (performance halls), concert halls and other places used for professional performance;
(5) Cultural heritage shops set up with permission from the administrative departments of culture;
(6) Enterprises engaged in the creation, publishing, and production of animation and cartoons as well as those engaged in the production and distribution of animation;
(7) Enterprises engaged in the production and distribution of broadcasting and television programs (including pay and digital broadcasting and television programs) as well as those engaged in the export of broadcasting programs, film, and television programs;

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[110] Notice on Certain Issues of Corporate Income Tax Incentives for the Enterprises Converted from Publicly-Funded Culture Institutions of Business Nature in Culture System Reform, Cai Shui [2009] No. 34, issued by the MOF and the SAT on March 26, 2009 and effective from January 1, 2009 to December 31, 2013.

[111] The Notice on Relevant Corporate Income Tax Policy Concerning Newly Established Culture Enterprise, Guo Shui Han [2010] No. 86, issued by the SAT on March 2, 2010; Article 1 of the Notice on Certain Tax Policy Issues Concerning Supporting the Development of Culture Enterprises during the Tryout Period for Culture Industry Reform, Cai Shui [2005] No. 2, issued by the MOF, General Administration of Customs, and the SAT on March 29, 2005.

[112] Cai Shui [2005] No. 2; Cai Shui [2009] No. 31.

(8) Enterprises engaged in the production, development, distribution, and screening of films (including digital films);
(9) Enterprises engaged in the pay operation of broadcasting and television channels, the integration, screening, and promotion of programs as well as the promotion of access services;
(10) Enterprises engaged in the cable transmission, wireless transmission, and satellite transmission of broadcasting programs, films, and television programs;
(11) Enterprises engaged in the mobile television, cell television, online television, video-on-demand programs and other kinds of audio and video businesses;
(12) Enterprises engaged in the self-development and transfer of intellectual property rights related to culture, arts, broadcasting programs, films, television programs, and publications as well as those engaged in the agency and trading of copyright;
(13) Enterprises engaged in the development and operation of online libraries, online newspapers, online journals, online audio and video products, online electronic publications, online game software, online arts, and online audio-visual products with permission from relevant administrative departments as well as those engaged in the online sale of publications;
(14) Enterprises engaged in the digital processing of publications, films, television programs, repertory works, music, art, and other cultural resources;
(15) Enterprises engaged in the publishing of books, newspapers, periodicals, audio-visual products, and electronic publications;
(16) Enterprises engaged in the logistics of publications; national or regional publication chain enterprises established with permission from relevant administrative departments and engaged in the operation or import and export of publications; retail-oriented publications enterprises located in localities of or below county level;
(17) Enterprises established with permission from the administrative departments of press and publication and engaged in the copying of read-only disks or the production of writable disks; and
(18) Enterprises engaged in the printing of books, newspapers, periodicals, audio-visual products and electronic publications by using digital printing technologies, computer-to-plate (CTP) technologies, automatic high-speed multi-color printing, high-speed binding lines and other hi-tech equipment.

8.14 Rural Finance

The State Council approved some tax incentives to support the development of finance in rural area. CIT incentives are provided to banks and insurance company in the form of

revenue exclusion. From January 1, 2009 to December 31, 2013, financial enterprises may include 90 percent of interest on small amount loans to farmers in computing taxable income for CIT purpose.[113] From January 1, 2009 to December 31, 2013, insurance enterprises may include 90 percent of its premium income derived from crop and aquaculture insurance businesses in computing its taxable income.[114] The "farmers" refers to the households who live in areas under the administration of townships and towns for more than one year (excluding residents of towns where county governments are located), the workers of State-owned farms, and the individual households engaging in industry and commerce in rural areas. The "farmers" also includes collective households of State-owned economic organizations, social groups, schools, and enterprises located in the areas under the administration of townships and towns (excluding residents of towns where county governments are located). Farmers can engage in agriculture or non-agriculture business. However, the people who have permanent resident permits in the qualified areas, but whose whole family has moved out for more than one year, are not considered "farmers" for this purpose. The "small amount loan" refers to a loan to one household where the loan balance is RMB50,000 or less.[115] Financial institutions should separately account for interest income from small amount loans to farmers; otherwise, the enterprises cannot enjoy the tax benefit.[116]

8.15 Transition Rules for Tax Incentives Granted under Old Tax Law and Regulations

The CIT Law provides certain relief to enterprises that enjoyed tax incentives under old tax laws during a five-year transaction period. An enterprise that enjoyed the preferential policy in the form of a reduced tax rate prior to January 1, 2008 will transit progressively from old preferential rates to new CIT rates in the five years following January 1, 2008. During this period, an enterprise that enjoyed the 15 percent enterprise income rate shall be subject to the 18 percent tax rate for the year 2008, 20 percent for the year 2009, 22 percent for the year 2010, 24 percent for the year 2011, and 25 percent for the year 2012; an enterprise that previously enjoyed the 24 percent tax rate shall be subject to the 25 percent tax rate starting with the year 2008. As of January 1, 2008, an enterprise that previously enjoyed fixed-term preferential enterprise income tax treatment in the form of tax reductions and exemptions, such as the "two-year tax exemption followed by three-year 50 percent reduction" shall continue to enjoy preferential treatment for their initial

[113] Article 2 of the Notice on Tax Policies Concerning Rural Finance, Cai Shui [2010] No. 4, issued by the MOF and the SAT on May 13, 2010.

[114] Article 4 of Cai Shui [2010] No. 4.

[115] Article 5 of Cai Shui [2010] No. 4.

[116] Article 6 of Cai Shui [2010] No. 4.

term as prescribed under the previous tax laws, administrative regulations, and related instruments after the CIT Law takes effect until the initial term expires; an enterprise that has not started enjoying preferential tax treatment because it has not made a profit shall commence the term of preferential tax treatment in the year 2008. To be eligible for the transitional preferential treatment, an enterprise must be established and complete business registration prior to March 16, 2007.[117] The State Council issued the "Table for Implementation of the Transitional Preferential Corporate Income Tax Policies" outlining specific eligibility and scope of the transitional preferential polities for qualified projects.

In spite of the transitional preferential tax treatments that are generally applicable to enterprises that have completed their business registrations prior to March 16, 2007, transitional tax incentives are available to newly established High and New Technology Enterprises in Shenzhen, Zhuhai, Shantou, Xiamen, and Hainan Special Economic Zones, and Shanghai Pudong New Area.[118] High and New Technology Enterprises are those certified under Article 93 of the CIT Implementation Rules and relevant administrative measures.[119] For the qualifications of High and New Technology Enterprises, please see Chapter 8.6. For High and New Technology Enterprises that complete the registration in the Special Economic Zones and Shanghai Pudong New Area on or after January 1, 2008, income derived from within the Special Economic Zones and Shanghai Pudong New Area shall, starting from the tax year during which revenue from production and business operations is first derived, be exempt from CIT in the first and second years, and be subject to 12.5 percent in the third through fifth years.[120] If an enterprise in those areas is engaged in production and business operation outside the Special Economic Zone or Shanghai Pudong New Area, the enterprise shall separately calculate its income derived from within Special Economic Zone or Shanghai Pudong New Area, and shall reasonably allocate its expenses for the corresponding period; where the enterprise does not conduct a separate calculation, it shall not enjoy preferential CIT treatment.[121] During the period, if an enterprise no longer qualifies as a High and New Technology Enterprise, the enterprise shall cease to enjoy the transitional preferential tax treatments and cannot resume or restart the enjoyment of the transitional preferential tax treatments

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117 Article 57 of the CIT Law; Article 1 of the Notice on the Implementation of the Transitional Preferential Corporate Income Tax Policies, Guo Fa [2007] No. 39, issued by the State Council on December 26, 2007.

118 Article 57 of the CIT Law; Article 1 of the Notice on the Implementation of the Transitional Preferential Tax Treatment of High and New Technology Enterprises Newly Established in Special Economic Zones and Shanghai Pudding New Area, Guo Fa [2007] No. 40, issued by the State Council on December 26, 2007 and effective on January 1, 2008.

119 Article 2 of Guo Fa [2007] No. 40.

120 Article 2 of Guo Fa [2007] No. 40.

121 Article 3 of Guo Fa [2007] No. 40.

even if the enterprise is subsequently recognized again as a High and New Technology Enterprise.[122]

In October 2000, the State Council issued polices concerning the extensive development of the Western Regions. [123] The polices include the principle of preferential tax treatment on investment in the Western Regions for the period from 2001 to 2010. To implement the State Council's policies, the MOF, the SAT, and the General Administration of Customs issued the preferential CIT policies for the extensive development of the Western Region.[124] Under those policies, a reduced CIT rate of 15 percent from January 1, 2001 through December 31, 2010 is applicable to enterprises set up in the Western Regions with its main business in encouraged industries according to relevant investment catalogs. For a domestic enterprise, 70 percent or more of its revenue should be derived from the business listed in The Catalog of Industries, Products, and Technologies Whose Development Are Currently Encouraged by the State (revised in 2000); for a foreign invested enterprise, 70 percent or more of its revenue should be derived from the business listed in The Catalog of Industries for Guiding Foreign Investment and the Catalog of Preferred Industries for Foreign Investment in Central and Western Region. Furthermore, an enterprise set up in the Western Region for which at least 70 percent of its total revenue is derived from the transportation, electricity, water conservancy, post, broadcasting, and television industries can enjoy two-year exemption and three-year 50 percent reduction from the first profit-making year for foreign invested enterprises and from the first operating year for domestic enterprises.[125] Those preferential tax policies will continue after the implementation of the CIT Law.[126] This means that an enterprise that is qualified for 15 percent tax rate can continue the preferential rate until December 31, 2010. As the State continues to encourage investment in the Western Regions, it is possible for the State to extent the existing tax preferential policies or provide new preferential tax treatment after 2010. However, it is not clear whether the State will continue or issue new policies in this regard.

[122] Article 4 of Guo Fa [2007] No. 40.

[123] The Notice on Policies Concerning Extensive Development of Western Regions, Guo Fa [2000] No. 33, issued by the State Council on October 26, 2000.

[124] The Notice on the Preferential Tax Policies for the Extensive Development of the Western regions, Cai Shui [2001] No. 202, jointly issued by the MOF, the SAT, and the General Administration of Customs on December 30, 2001 and effective on January 1, 2001. The Western Regions include Chongqing, Sichuan, Guizhou, Yunnan, Tibet, Shanxi, Gansu, Ningxia, Qinghai, Xinjiang, Inner Mongolian, and Guangxi. The preferential publicities for Western Regions also apply to Xiangxi Tujia-Miao Autonomous Prefecture in Hunan Province, Enshi Tujia-Miao Autonomous Prefecture in Hubei Province and Yanbian Korean Autonomous Prefecture in Jilin Province.

[125] Cai Shui [2001] No. 202.

[126] Article 2 of Guo Fa [2007] No. 39.

8.16 Local Tax Incentives

CIT is a tax imposed under national tax law. Local governments are not authorized to impose local income tax on enterprises. CIT of an enterprise is generally collected by the tax bureau at the location (district, county, city, etc.) where the enterprise is registered with exception of collection of certain branch income by the tax bureaus where some branches of the enterprise are located. The CIT revenue so collected is shared between the State Treasury and the local government based on prescribed percentage. Typically, 40 percent of CIT revenue is retained by local government and 60 percent is forwarded to the State Treasury. The autonomous government authorities of ethnic autonomous regions may decide to grant a reduction or exemption of the CIT to the enterprises located within their jurisdictions for such part of CIT as retained by ethnic autonomous regions. If autonomous prefectures and counties decide to grant such tax reductions or exemptions, such decision must be approved by the governments of relevant provinces, autonomous regions or municipalities.[127] The local governments that are authorized by the CIT Law to grant such local CIT incentives are the autonomous regions, autonomous prefectures, and autonomous counties with regional ethnic autonomy in accordance with the Law of the PRC on Ethnic Regional Autonomy.[128]

Local governments, other than the ethnic autonomous regions, prefectures and counties, have not been authorized to grant CIT reductions or exemptions based on local law and regulations. To attract investments in local areas, many local governments provided various tax refunds to enterprises established in their jurisdictions. In 2000, the State Council ordered local governments to stop tax refund practice from January 1, 2000.[129] This order, however, has not been completely followed by many local governments. In 2001, the State Council made a special audit of nine provinces and municipalities on the implementation of the State Council order. The State Council found that many local government had continued the tax refund practices and some of them had issued new tax refund polices. The State Council further requested that local governments follow the order of the central government and correct any unauthorized practices.[130]

Instead of giving tax refunds, some local governments set up local development funds and offer financial subsidies paid out of the development funds to the enterprises established in their regions. Some of such subsidies would be equal to full CIT or a portion of CIT paid by a recipient enterprise and retained by the local government. Such subsidies

[127] Article 29 of the CIT Law.

[128] Article 94 of the CIT Implementation Rules.

[129] Notice on the Correction of Tax Refund Policies of Local Governments, Guo Fa [2000] No. 2, issued by the State Council on January 11, 2000.

[130] Notice on Issues Concerning the Polices on Tax Reductions or Exemptions Such As Collecting First and Refund Later Made by Some Local Governments in Violation of Regulations, Guo Ban Fa [2002] No. 5, Issued by the General Office of the State Council on January 16, 2002.

are often available for a fixed period. The tax bureau at the location will collect the full amount of CIT and the finance bureau of the local government will provide the cash subsidies. In essence, this is a form of tax refund. Those subsidies may or may not be based on written local regulations. More often, the percentage of "refund" is subject to negotiation between the investor and the local government. It is questionable whether those financial subsidies are in compliance with CIT Law and national policy. Even if this practice is not in line with national policy, the recipient enterprises or their investors should not be at fault for merely receiving the subsidies. Furthermore, there is no guarantee that the financial subsidies offered will actually be provided throughout all the promised years.

9

INCOME FROM FOREIGN COUNTRIES AND REGIONS

China resident enterprises are taxed on worldwide income.[1] Resident enterprises engaged in activities abroad generally compute taxable income from foreign countries or regions in the same manner as those operating within China. However, foreign countries and regions may also impose taxes on the same income. To eliminate double taxation, the CIT Law and the CIT Implementation Rules allow an enterprise to credit income tax paid in foreign countries and regions against CIT, subject to certain limitations. China has adopted the rule of foreign credit limitation by country. Because of this limitation, taxable income and foreign tax credit by country have become important in implementing the foreign tax credit policy. Anti-avoidance rules are also adopted to prevent certain deferral of CIT on foreign income. For China tax purposes, Hong Kong SAR, Macau SAR and Taiwan are treated as foreign regions; the same tax treatments for foreign countries apply to these regions.

9.1 Taxable Income from Foreign Country or Region

Foreign income of an enterprise includes income derived by the enterprise from direct business activities in or related to foreign countries and from return of investment in

[1] Article 3 of the CIT Law.

foreign countries including the profits of its foreign subsidiaries in the form of dividends. The enterprise is required to properly compute taxable income by country and region in accordance with the CIT Law and the CIT implementation Rules.

9.1.1 COMPUTATION OF TAXABLE INCOME OF FOREIGN BRANCH

A foreign branch of a resident enterprise is an entity established in a foreign country or region that is not a separate taxpayer. An entity without separate taxpayer status refers to the entity that is not a separate legal person according to the law where the entity is established or that is not considered as a resident of the country in accordance with applicable tax treaty. [2] Such an entity without separate taxpayer status includes a branch, a representative office, a liaison office, and an establishment or place of business where the resident enterprise provides services and is subject to tax in a foreign country.[3] An enterprise should include income of foreign branches in computing its taxable income from foreign countries in the relevant tax year regardless of whether such income is repatriated back to China. The revenue and expenses of branches are determined in accordance with the relevant provisions of the CIT Law and the CIT Implementation Rules.[4] The reasonable expenses of foreign branches commonly include salary expenses, depreciation expenses, interest expenses, relevant taxes, and allocated headquarters expenses.[5] As such, the taxable income computed for foreign tax reporting purposes under foreign tax law may need to be adjusted in accordance with Chinese tax rules.

The losses of a branch in a foreign country cannot offset income derived from China or income from other foreign countries; such losses can be used to offset income from the same country in the current year and subsequent five years.[6] However, if the sum of domestic and foreign sourced income of an enterprise is positive, the unused loss of a foreign branch due to the restriction on the offsetting can be carried forward without the five-year limitation.[7] For example, a resident enterprise has combined income of RMB4 million, including RMB5 million income within China and foreign sourced loss of RMB1 million from its only foreign branch. Because the RMB1 million loss of the foreign branch cannot offset domestic income, the enterprise should have taxable income of RMB5 million. The RMB 1 million loss can be used to offset the income from the foreign branch or other income from the same country in any subsequent years without

[2] Article 13 of the Notice on the Issues Concerning Foreign Tax Credits, Cai Shui [2009] No. 125, issued by the MOF and the SAT on December 25, 2009 and effective on January 1, 2008.

[3] Article 40 of Operational Guidance to Foreign Tax Credits, issued by the SAT via SAT Gong Gao 2010 No. 1 on July 2, 2010 (hereafter "FTC Operational Guidance").

[4] Article 3(1) of Cai Shui [2009] No. 125.

[5] Article 8 of FTC Operational Guidance.

[6] Article 3(5) of Cai Shui [2009] No. 125.

[7] Article 14 of FTC Operational Guidance.

the five-year limitation. However, if had a combined loss of RMB0.6 million, comprising domestic income of RMB0.4 million and foreign branch loss of RMB1 million, the taxable income of the enterprise would be RMB0.4 million; the RMB1 million foreign branch loss can be carried forward to offset future income from the branch country. The RMB1 million loss carryover, however, should be divided into two categories, a non-actual loss of RMB0.4 million, which can be carried forward indefinitely, and an actual loss of RMB0.6 million, which can be carried forward for five years.

Where a resident enterprise operates a foreign branch and if the tax year of such branch is not the same as the tax year of the resident enterprise in China, the tax year for the foreign branch ending on a date within the enterprise's tax year in China should be included in the resident enterprise for the tax year.[8] For example, suppose a resident enterprise's tax year is the calendar year and its foreign branch has a tax year from April 1 to March 31. For the annual CIT return for 2010, the enterprise should include its income from January 1, 2010 to December 31 and its branch income from April 1, 2009 to March 31, 2010.

9.1.2 COMPUTATION OF TAXABLE INCOME FROM OTHER FOREIGN SOURCES

Where a resident enterprise derives dividends or other profit distribution on equity, interest, rental income, royalties, and gains on property transfer from foreign countries, the taxable income is the revenue less reasonable expenses relevant to those income items in accordance with the relevant provisions of the CIT Law and the CIT Implementation Rules. Dividends, profit distributions, and other returns on equity investments in foreign countries should be recognized as income by a resident enterprise on the date of declaration of dividend by the investee company. The interest, rent, royalties, and gain on property transfer derived from a foreign country should be recognized as income by a resident enterprise on the date of payment as provided in the relevant contracts.[9]

Where a resident enterprise receives income net of creditable foreign taxes paid, the resident enterprise should gross up the income adding back direct and indirect foreign taxes.[10] For example, resident enterprise P receives RMB63 net dividend from its 100 percent owned subsidiary S in Country X. S paid RMB30 income tax in Country X on its RMB100 profit and distributes its after-tax profit of RMB70 to P. Country X imposes 10 percent withholding tax (or RMB7) on the dividend. In computing its taxable income, P should add back RMB30 tax paid by S and RMB7 withholding tax; as such, the inclusion of dividend income should be RMB100.

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[8] Article 11 of Cai Shui [2009] No. 125.

[9] Article 3(2) of Cai Shui [2009] No. 125.

[10] Article 4 of FTC Operational Guidance.

After the gross-up of foreign sourced income such as dividend and interest, the enterprise should adjust costs and expenses that are relevant to foreign income and have been deducted in computing the total income of the enterprise. The enterprise should properly allocate those costs and expenses to derive taxable income from foreign sources. The SAT draws special attention to the following expenses in such adjustment:[11]

Income item	Expenses related to income
Dividends	Project study expenses, financing costs, management fees in relation to the investment,
Interest	Financing costs and other relevant expenses
Rent	Financing costs for finance leasing business; depreciation for operating leasing business
Royalties	R&D expenses, amortization, etc.
Transfer of property	Tax basis of property and relevant expenses

9.1.3 FOREIGN SOURCED INCOME OF NON-RESIDENT

If a non-resident derives income outside China that is effectively connected with an establishment or place of business of the non-resident enterprise in China, the non-resident enterprise should compute its foreign source taxable income that is effectively connected with the China establishment or place of business by reference to the treatments of other income to resident enterprises as discussed in Section 9.1.2.[12] Similar to a resident enterprise, the CIT Law allows the non-resident enterprise to take foreign tax credits against China tax liability with respect to income effectively connected with its establishment or place of business in China. A typical example is that a China branch of a foreign bank makes a loan to an entity outside China. Interest income derived by the branch from the loan is foreign sourced income effectively connected with the branch.[13]

9.1.4 ALLOCATION OF COMMON EXPENSES

In computing taxable income from foreign countries, an enterprise should allocate common expenses to each country. Such common expenses are those related to foreign income but not included in the expenses of any foreign country. They may include business expenses, administrative expenses and financing expenses. An enterprise may

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[11] Article 9 of FTC Operational Guidance.

[12] Article 3(3) of Cai Shui [2009] No. 125.

[13] Article 1 of FTC Operational Guidance.

use one or more factors to apportion the common expenses to each country. The factors may include asset, income, salary, and other appropriate items. Once an enterprise adopts the apportionment factors, it should file the method with the tax authority in charge; it cannot change the method without proper reasons.[14]

9.2 Foreign Tax Credit

When an enterprise earns income in a foreign country or region, the income may be subject to income tax in the foreign jurisdiction. As a resident enterprise is subject to China tax on its worldwide income, the foreign income earned by the enterprise may be subject to double taxation in both the foreign jurisdiction and China. In order to release enterprises from double taxation, the CIT Law authorizes the foreign tax credit subject to limitation. The allowable foreign tax credit includes both direct foreign tax credit and indirect foreign tax credit.

A resident enterprise may claim foreign tax credit for foreign income tax paid on its taxable income from sources outside China.[15] A non-resident enterprise may claim foreign tax credit for foreign income tax paid on its taxable income from sources outside China that is effectively connected with the establishment or place of business of such non-resident enterprise within China.[16] It is not common for a non-resident enterprise to conduct both inbound and outbound activities through its establishment or place of business in China, as the operations in the form of branches are not available to foreign enterprises, in practice, except for limited areas. However, tax credit is available for non-resident enterprises if they do receive foreign sourced income in connect with their China establishments.

9.2.1 CREDITABLE TAXES

Creditable taxes are the taxes in the nature of CIT and actually paid by an enterprise on income derived from sources outside China in accordance with the tax laws and regulations of foreign countries or regions. [17] Creditable tax does not include:[18]

(1) Tax paid by an enterprise or collected by a foreign country or region by mistake;

[14] Article 12 of FTC Operational Guidance.

[15] Article 23(1) of the CIT Law.

[16] Article 23(2) of the CIT Law.

[17] Article 23 of the CIT Law; Article 77 of the CIT Implementation Rules.

[18] Article 4 Cai Shui [2009] No. 125; Article 16 of FTC Operational Guidance.

(2) Tax in excess of limitation as provided by applicable tax treaties. If an enterprise paid tax on income in accordance with domestic law of a foreign country and, however, the applicable tax treaty provides for an exemption of tax on such income, then the enterprise cannot claim foreign tax credit in China on such tax paid. Similarly, if an enterprise paid tax at a tax rate higher than that provided in an applicable tax treaty, the excess portion will not be creditable;
(3) Interest, late payment charges, and penalties for underpayment or late payment of tax;
(4) Tax paid and subsequently refunded. Some countries may provide tax incentives by refunding tax in various forms. As an enterprise has not actually paid the portion refunded, such amount is not creditable;
(5) Foreign tax on income that is exempted from CIT under the CIT Law; and
(6) Tax that has been deducted in computing taxable income in accordance with the regulations prescribed by the departments of the State Council in charge of finance and taxation. If Chinese tax law and regulations provides that foreign tax paid on an income item can only be deducted as an expense in computing CIT, such tax paid cannot be credited.

However, if an enterprise is granted a tax exemption or reduction by a foreign country and the applicable tax treaty provides that amount of tax exempted or reduced is deemed to have been paid, then the deemed paid tax is creditable and enterprise may claim a tax sparing credit.

As CIT is a tax on profits, creditable foreign tax should be similar tax based on net profits regardless of the names of the tax. Some foreign countries may impose a minimum tax based on gross income as an alternative to profit-based income tax. For example, an enterprise may be required to pay the higher amount of a minimum tax based on a percentage of gross income and the regular income tax based on profit. Double taxation treaties usually list applicable taxes. If a non-net profit-based tax such as a minimum tax is included in the applicable tax list, such tax from treaty countries should be creditable. If a tax is not described in an applicable tax treaty or the income is from a non-treaty country, and if a tax bureau cannot determine whether such foreign tax is income tax on enterprises, the tax bureau may ask for a ruling from the SAT.[19] Taxes other than income tax such as value-added tax and sales tax are not creditable. These other taxes, if related to the business operations of an enterprise, can be deducted as expenses.

The actual payment requirement for foreign tax credit may cause timing issues for taxpayers. Enterprises are required to file their annual CIT returns on or before May 31

[19] Article 15 of FTC Operational Guidance.

following a tax year; however, income tax returns in foreign countries may be filed after the Chinese tax return filing date. For example, if a resident enterprise having a foreign branch files its China annual CIT return for Year 1 in May Year 2 and its foreign return in September Year 2, the enterprise may not know its actual foreign tax liability for Year 1 until September Year 2. Furthermore, to claim foreign tax credit, the enterprise must obtain the official evidence of actual tax payment. If the enterprise has not obtained such evidence by May 31, Year 2, it will not be able to claim foreign tax credit for Year 1 on its annual CIT turn. Even if the enterprise paid estimated tax in the foreign country during Year 1, it is questionable whether the estimated tax should be considered as "tax payable and actually paid." If the enterprise obtains the tax payment evidence after May 31, Year 2, it then can recompute its foreign tax credit for Year 1.[20]

Where foreign tax is paid in a foreign currency, such tax should be converted into RMB to compute the amount of foreign tax credit. If an enterprise's functional currency is RMB, the enterprise should convert the foreign tax into RMB using the exchange rate at the time that the enterprise recognizes such foreign income. If an enterprise's functional currency is not in RMB, the exchange rate should be the mid-rate on the last day of the tax year in which such foreign income is recognized.[21]

9.2.2 DIRECT FOREIGN TAX CREDIT

Direct foreign tax credit is the amount of foreign income tax paid by an enterprise as a taxpayer. Direct foreign tax credit mainly applies to foreign tax paid by a resident enterprise on its business profits derived from foreign operations such as branch operations. Direct foreign tax credit also applies to the withholding tax paid by an enterprise on dividends, interest, rents, royalties, and the gain on transfer of property derived from foreign countries and regions.[22] The computation of direct foreign tax credit is not complicated. An enterprise should include foreign source income including foreign income tax in its gross income and then credit foreign tax against its China CIT subject to limitation. For example, if an enterprise has foreign taxable income of RMB100 and paid foreign income tax of RMB20, the China CIT liability on the RMB100 foreign income is RMB25; the enterprise only need to pay RMB5 to the China tax authority because the foreign tax credit reduces China CIT liability by RMB20.

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[20] Article 10 of FTC Operational Guidance.

[21] Article 17 of FTC Operational Guidance.

[22] Article 2 of FTC Operational Guidance.

9.2.3 INDIRECT FOREIGN TAX CREDIT

9.2.3.1 Eligible Foreign Company

If a resident enterprise operates abroad through a subsidiary, the income earned by the subsidiary normally is not taxable in China until the profits of the subsidiary are distributed to the resident enterprise. The resident enterprise cannot credit foreign tax paid by the subsidiary before the inclusion of the subsidiary's profits in the taxable income of resident enterprise. However, when the foreign subsidiary declares dividends to the resident enterprise, the resident enterprise may claim indirect foreign tax credit. The CIT Law authorizes indirect foreign tax credit for a portion of foreign income tax paid by a foreign enterprise that is attributable to the dividends received by the resident enterprise.[23] In order to qualify for foreign tax paid by a foreign enterprise as an indirect foreign tax credit, a resident enterprise must directly or indirectly own at least 20 percent of equity interest in the foreign enterprise.[24] The MOF and SAT clarify that an enterprise may claim indirect foreign tax credit for income tax paid by three tiers of foreign subsidiaries. The MOF and SAT provide the following guidance on the computation of direct or indirect ownership of 20 percent:[25]

(1) For a first-tier foreign subsidiary, the resident enterprise must directly own 20 percent or more of the subsidiary;
(2) For a second-tier foreign subsidiary, one first-tier subsidiary must directly own 20 percent or more of the second-tier subsidiary, and the resident enterprise must directly or indirectly, through eligible foreign subsidiaries, own 20 percent or more of the second-tier subsidiary; and
(3) For a third-tier foreign subsidiary, one second-tier subsidiary must directly own 20 percent or more of the third-tier subsidiary, and the resident enterprise must directly or indirectly, through eligible foreign subsidiaries, own 20 percent or more of the third-tier subsidiary.

In computing an indirect ownership of a resident enterprise in a second-tier or third-tier foreign subsidiary, the includable percentage must owned through a chain of foreign enterprises connected through equity ownership of at least 20 percent. This means that each upper tier company must directly owns at least 20 percent of the

[23] Article 24 of the CIT Law.
[24] Article 80 of the CIT Implementation Rules.
[25] Article 6 Cai Shui [2009] No. 125.

immediate lowr tier company.[26] The following diagrams illustrate the computation of direct and indirect 20 percent ownership:

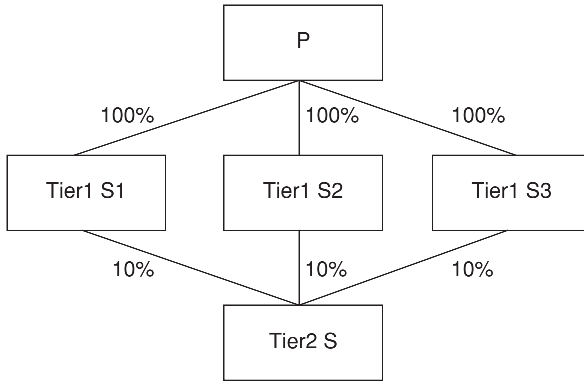

FIGURE 9.2.3–1

In Figure 9.2.3–1, resident enterprise P indirectly owns 30 percent of second-tier foreign subsidiary Tier2 S. However, none of the first-tier foreign subsidiaries directly owns 20 percent or more of Tier2 S. Therefore, foreign income tax paid by Tier2 S will not be creditable by P.

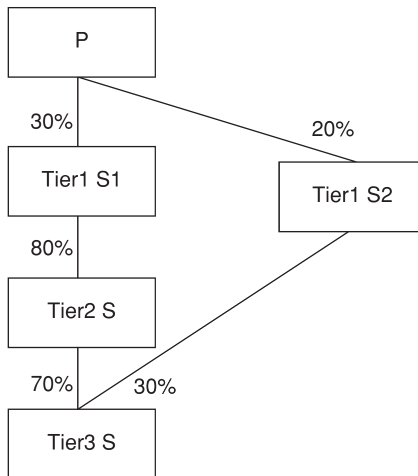

FIGURE 9.2.3–2

In Figure 9.2.3–2, Tier2 S is an eligible foreign subsidiary for indirect foreign tax credit purpose because Tier1 S1 directly owns 80 percent of Tier2 S and P indirectly owns 24 percent of Tier2 S. Tier3 S is also an eligible foreign subsidiary for indirect foreign tax

[26] Article 21 of FTC Operational Guidance.

credit purposes because Tier2 S directly owns 70 percent of Tier3 S and P indirectly owns 22.8 percent (16.8 percent through Tier1 S1 and Tire2 S plus 6 percent through Tier1 S2) of Tier3 S.

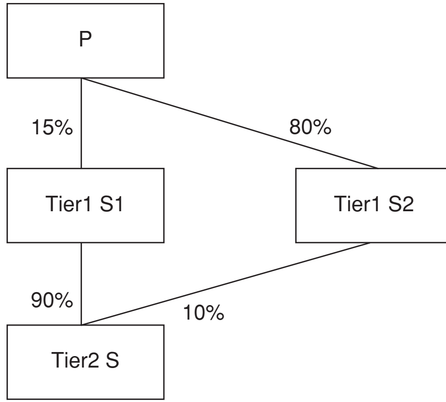

FIGURE 9.2.3–3

In Figure 9.2.3–3, Tier1 S1 directly owns 90 percent of Tier2 S and P indirectly own 21.5 percent (13.5 percent through Tier1 S1 and 8 percent through Tier1 S2) of Tier2 S. However, Tier1 S1 is not an eligible foreign subsidiary for foreign tax credit purposes because P's ownership in Tier1 S1 is less than 20 percent. In computing P's indirect ownership in Tier2 S, P's 13.5 percent indirect ownership in Tier2 S through Tier1 S1 should not be included because Tier1 S1 is not an eligible foreign subsidiary. Furthermore, P's 8 percent indirect ownership in Tier2 S through Tier1 S2 should also be excluded in computjing P's indirect ownership in Tier2 S because Tier1 S2 owns less than 20 percent of Tier2 S, although Tier1 S2 itself is an eligible foreign subsidiary. As such, P's direct and indirect ownership in Tier2 S is 0 percent; Tier2 S is not an eligible foreign subsidiary for foreign tax credit purposes.

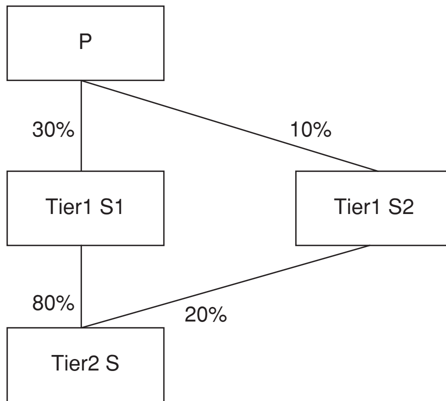

FIGURE 9.2.3–4

In Figure 9.2.3–4, Tier1 S1 is an eligible foreign subsidiary because P directly owns 30 percent of Tier1 S1. Tier2 S is an eligible foreign subsidiary because Tier1 S1 directly owns 80 percent and P indirectly owns, through Tier1 S1, 24 percent of Tier2 S. P also indirectly owns 2 percent of Tier2 S through Tire1 S2. However, this 2 percent indirect ownership should not be counted because Tier1 S2 is not an eligible foreign subsidiary. As such, when the profits of Tier2 S are distributed to P through Tier1 S1 and Tier1 S2, only the portion of tax paid by Tier2 S associated with dividend through Tier1 S1 is creditable tax; the portion through Tier1 S2 is not.

In spite of the requirement of a minimum 20 percent participation in eligible foreign companies, some tax treaties may provide a lower percentage of participation. For example, some China tax treaties require 10 percent participation for a China resident enterprise to claim indirect foreign tax credit in relation to dividends received from a company in a foreign treaty country. In such case, the China resident enterprise can claim indirect foreign tax credit under the tax treaty even if its ownership in the dividend paying company is less than 20 percent. The lower percentage of ownership only applies to direct ownership of a China resident enterprise in a first-tier foreign company; a China resident enterprise cannot claim indirect tax credit under tax treaties for a second-tier or third-tier foreign company.

9.2.3.2 Computation of Indirect Credit

Foreign tax paid and attributable to the dividend received by a resident enterprise should be computed from the lowest tier of creditable foreign subsidiary. The following formula is used to allocate a portion of foreign income taxes paid by a foreign subsidiary to the dividend distribution:[27]

$$\begin{aligned}\text{Tax allocated to dividend} = {} & (\text{Tax paid by a foreign company} \\ & + \text{Tax paid by its subsidiary allocated to dividend received}) \\ & \times \text{Dividend paid to parent company} \\ & \div \text{After tax profits of the foreign company}\end{aligned}$$

The formula basically requires that a foreign income tax pool and an after-tax profit pool are computed and maintained for each foreign subsidiary. When the subsidiary distributes dividends, foreign income tax will be allocated to dividend distribution and deducted from the tax pool. As a foreign subsidiary may not distribute all earnings each year, it will be important for taxpayers to obtain and maintain evidence to prove the actual payment of foreign income taxes and detailed computation of allocation of such tax to dividend distribution.

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[27] Article 5 Cai Shui [2009] No. 125.

The following example illustrates such indirect foreign tax credit computation:

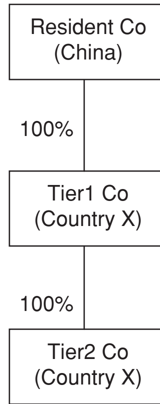


FIGURE 9.2.3–5

Resident Co., a resident enterprise, owns 100 percent of Tier1 Co, which in turn owns 100 percent of Tier2 Co. Both Tier1 Co and Tier2 Co are located in the same foreign country. The after-tax profits (excluding profits of subsidiary), income tax paid, and dividend distribution are as follows:

	Year 1		Year 2	
	Tier2 Co	Tier1 Co	Tier 2 Co	Tier1 Co
After-tax profits	70	160	150	240
Income tax paid	30	40	50	60
Dividend paid	60	0	100	280

We compute tax paid and attributable to dividends from the lowest tier subsidiary. For Year 1, Tier2 Co paid 60 of dividend out of 70 after tax profit. Foreign tax paid by Tier2 Co and attributable to dividends distributed to Tier1 Co is computed as follows:

$$\text{Tax allocated to dividends} = 30 \text{ tax} \times 60 \text{ dividend} \div 70 \text{ profit} = 25.7$$

After the dividend payment for Year 1, Tier2 Co has a remaining net profit of 10 with foreign tax paid of 4.3 (30-25.7).

Resident Co cannot claim foreign tax credit for Year 1 because Tier2 Co did not pay dividends to Resident Co.

At the end of Year 2, Tier2 Co had a profit pool of 160 (150 current profit plus 10 Year 1 profit) and a tax pool of 54.3 (50 current year plus 4.3 from prior year). Tax allocated to dividend paid from Tier2 Co to Tier1 Co for Year 2 is computed as follows:

$$\text{Tax allocated to dividend} = 54.3 \text{ tax} \times 100 \text{ dividend} \div 160 \text{ profit} = 33.9$$

After the dividend distribution from Tier2 Co to Tier1 Co for Year 2, Tier1 Co had the following profit pool and tax pool:

Tier1 Co profit for Year 1	160
Dividend received from Tier2 Co for Year 1	60
Tier1 Co profit for Year 2	240
Dividend received from Tier2 Co for Year 2	100
Total profit	560

Tax paid by Tier1 Co for Year 1	40
Tax paid by Tier2 Co allocated to dividend for Year 1	25.7
Tax paid by Tier1 Co for Year 2	60
Tax paid by Tier2 Co allocated to dividend for Year 2	33.9
Total tax paid	159.6

Foreign tax paid and allocated to dividend to Resident Co is computed as follows:

$$\text{Tax allocated to dividend} = 159.6 \text{ tax} \times 280 \text{ dividend} \div 560 \text{ profit} = 79.8$$

Resident Co's foreign tax credit for Year 2 is 79.8 subject to limitation that may be imposed.

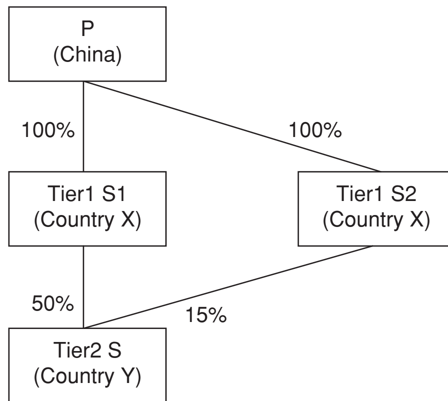


FIGURE 9.2.3–6

In this example in Figure 9.2.3–6, Tier2 S had taxable income of 100 and paid corporate income tax in Country Y at 20 percent. Tier2 S distributed 60 dividends out of its net profit of 80. Country Y imposed 10 percent withholding tax on dividend distribution. Tier1 S1 and Tier1 S2 each had taxable income of 100 and applicable tax rate of 30 percent. Country X did not impose tax on foreign dividends and did not tax on dividend distribution. Tier1 S1 and Tier1 S2 distributed all after tax profits to P.

For Tier2 S, income tax paid to Country X is 20 (100 x 20%); gross dividend paid to Tier1 S1 is 30 (60 x 50%) and to Tier1 S2 is 9 (60 x 15%). Tax paid by Tier2 S associated with the dividend paid to Tire1 S1 is calculated as follows:

$$\text{Tax } 20 \times \text{Dividend } 30 \div \text{After tax profits } 80 = 7.5$$

Tier1 S2 owns only 15 percent of Tier2 S; tax paid by Tier2 S associated with the dividends paid to Tier1 S2 is not creditable.

For Tier1 S1:

$$\text{Withholding tax paid to Country Y} = \text{Dividend } 30 \times 10\% = 3$$

$$\text{Tax paid to Country X} = 100 \times 30\% = 30$$

$$\text{Total after tax profit} = \text{profit from operation } 70 + \text{Net dividend } 27 = 97$$

Tax paid associated with dividend to P = (Tax to Country X 30 + Tax on dividend from Tier2 S 10.5) x Dividend to P 97 ÷ After tax profits 97 = 40.5. The 10.5 of tax on dividend from Tier2 S includes 7.5 tax on Tier2 S's profit and 3 of withholding tax on Tier2 S's dividends to Tier1 S1.

P's indirect tax credit is 40.5.

9.2.4 LIMITATIONS ON FOREIGN TAX CREDIT

The CIT Law imposes limitations on foreign tax credit; the amount of foreign tax credit cannot exceed the CIT otherwise payable on the income calculated in accordance with the CIT Law.[28] The object of this limitation is to prevent foreign income taxes from reducing CIT on China source income. Suppose P, a resident enterprise, earns net income of RMB1,000,000 from business activities in Foreign Country X and RMB2,000,000 of income from China sources. Assume applicable CIT rate is 25 percent while Country X tax rate is 35 percent. The CIT liability on the RMB3,000,000 of worldwide income is RMB750,000. Absent a limitation provision, P could credit the RMB350,000 of Country X tax against CIT liability, leaving a net CIT liability of RMB400,000, or an effective tax rate of only 20 percent on the RMB2,000,000 of China source income.

The CIT Implementation Rules adopt the foreign tax credit limitation on a per-country basis. The intention of the per-country limitation is to prevent a taxpayer from

[28] Article 23 of the CIT Law.

averaging the income of a high-tax country with the income of a low-tax country. The per-country limitation is calculated using the following formula:[29]

Tax credit limitation = Total tax payable on income derived from both within and outside China as calculated in accordance with China tax law
× Taxable income from the particular foreign country (region)
÷ Total taxable income derived from both within and outside China

The per-country tax credit limitation is the maximum amount of tax credit for income tax paid in the country that can be used in the current year against China income tax liability. As such, the actual credit for income tax of a country is the lesser of the actual tax paid and the amount of limitation. The amount of foreign tax paid in excess of the limitation may be carried forward and credited against the CIT liability in any of the subsequent five years. An enterprise can only use foreign tax credit carryovers after it utilizes the foreign tax credit arising in current year.[30] Because of per-country limitation, an enterprise will not be able to use foreign tax credit carryovers with respect to a particular country unless the enterprise can derive income from the foreign country that is taxed at a rate lower than applicable CIT rate.

Suppose that Resident Co has income from the following sources:

Source	Taxable income	Foreign tax
China	700	
Foreign country A	200	40
Foreign country B	100	30
Total	1000	70

Resident Co should compute foreign tax credit limitation for foreign country A and foreign country B separately:

Total tax payable on income derived from both within and outside China as calculated in accordance with China tax law = 1000 × 25% = 250

Limitation for country A = 250 × 200 ÷ 1000 = 50

Limitation for country B = 250 × 100 ÷ 1000 = 25

[29] Article 78 of the CIT Implementation Rules.

[30] Article 23 of the CIT Law.

Foreign tax paid on income derived from foreign country A is 40, which is less than the limitation of 50. As such, allowable credit is 40, actual tax paid, for country A income. Foreign tax paid on income derived from foreign country B is 30, which is more than the limitation of 25. As such, allowable credit against current year China tax liability is 25 for country B; the excess credit of 5 can be carried forward for five years.

The legal structure for international operations of a company can be complex. It is common for a resident enterprise to hold operating subsidiaries through one or more holding companies that may not be in the same country as operating subsidiaries. Figure 9.2.4–1 below shows a possible international investment structure of a resident enterprise.

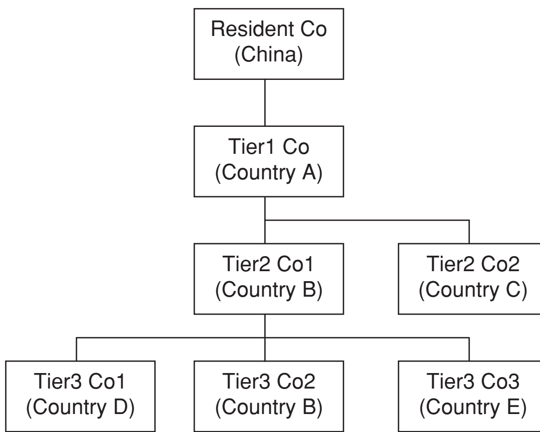
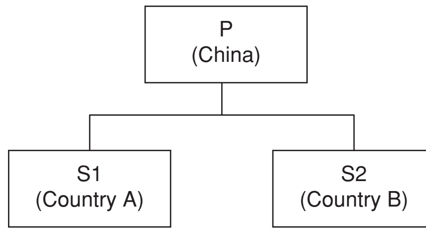


FIGURE 9.2.4–1

The CIT Law and the CIT Implementation Rules do not provide how the per-country foreign tax credit limitation rule should apply to a structure like this. When Tier1 Co distributes dividends to Resident Co, the amount of dividend may include profits from lower-tier subsidiaries. It would be very complicated if Resident Co were required to trace the dividend to the profits from each country and compute foreign tax credit and limitation for each country (i.e., Countries A, B, C, D, and E) in relation to the dividend. According to the FTC Operational Guidance, the per-country foreign tax credit limitation is computed based on per first-tier subsidiary country; all eligible lower-tier subsidiaries under a first-tier subsidiary are treated as entities in the country of the first-tier subsidiary for the purposes of computation of foreign credit limitation. According to this interpretation, in the structure diagrammed above, the amount of dividends paid by Tier1 Co to Resident Co will be treated as income from Country A; taxes paid by all subsidiaries to all foreign countries will be treated as being paid to Country A. The SAT's interpretation of per country limitation rule actually will allow a first-tier foreign subsidiary to serve as a mixer. The examples below illustrate this effect.



	P	S1	S2	Total
Taxable income before expense allocation	500	200	100	800
Applicable tax rate	25%	10%	40%	
Foreign income tax paid		20	40	
Net profit per local book		180	60	
Adjustment to income due to expense allocation	60	(40)	(20)	0
Taxable income under CIT Law	560	160	80	800

FIGURE 9.2.4–2

As illustrated in Figure 9.2.4–2, suppose P, a resident enterprise, own 100 percent of S1 and S2, corporations established in Country A and Country B respectively. Tax rate in Country A is 10 percent and Country B 40 percent. Both countries do not impose withholding tax on dividend distribution. S1 and S2 distributes all of their after tax profits to P as dividends. The taxable income from China source, Country A, and Country B computed in accordance with the CIT Law are 560, 160, and 80, respectively.

Total tax payable on income derived from both within and outside China as calculated in accordance with China tax law is 200 (800 x 25%). Tax credit limitation for each country is calculated as follows:

$$\text{Credit limitation for Country A} = 200 \times 160 \div 800 = 40$$

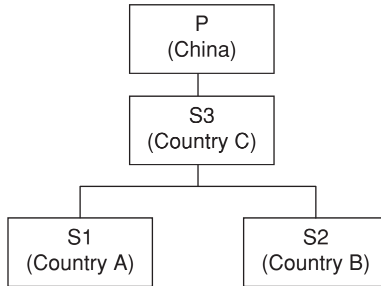
$$\text{Credit limitation for Country B} = 200 \times 80 \div 800 = 20$$

As actual tax paid in Country A is 20, P can only credit 20 for Country A. The actual tax paid in Country B is 40, which is greater than the credit limitation for Country B; P can only credit 20 for Country B. The remaining 20 of foreign tax credit can be carried forward for five years against CIT tax liability on income derived from Country B.

$$\text{P's actual CIT liability} = 200 - 20 \text{ credit for A} - 20 \text{ credit for B} = 160$$

The combined tax liability for P and subsidiaries is 220, comprising 160 for China, 20 for Country A and 40 for Country B.

Suppose P, instead of directly owning S1 and S2 in the above example, sets up a holding company S3 in Country C, a jurisdiction that does not tax on foreign dividends and dividend distribution. S3 owns S1 and S2 (see Figure 9.2.4–3).



	P	S1	S2	S3	Total
Taxable income before expense allocation	500	200	100	0	800
Applicable tax rate	25%	10%	40%		
Foreign income tax paid		20	40	0	
Net profit per local book		180	60		
Adjustment to income due to expense allocation	60	(40)	(20)	0	0
Taxable income under CIT Law	560	160	80	0	800

FIGURE 9.2.4–3

As the per-country limitation rule only applies to countries in first-tier subsidiaries, the income of S1, S2, and S3 will be considered deriving from Country C; taxes paid by S1 and S2 will be treated as being paid to Country C.

$$\text{Credit limitation for Country C} = 200 \times (160+80+0) \div 800 = 60$$

$$\text{P's actual CIT liability} = 200 - 60 \text{ credit} = 140$$

The combined tax liability for P and subsidiaries is 200, comprising 140 for China, 20 for Country A and 40 for Country B.

Due to S3, P's is able to average the income of Country A and income of Country B and therefore increase foreign tax credit limitation by 20. As such, the current per-country limitation rule would offer planning opportunities to improve foreign tax credit position.

9.2.5 SIMPLIFIED METHOD

A simplified method to avoid complicated calculations of per-country limitations is to claim foreign tax credit using the "deemed credit method." Prior to January 1, 2008,

a Chinese enterprise was allowed to elect, upon the approval of tax authority, to use 16.5 percent of foreign source taxable income as deemed tax credit regardless of actual foreign tax paid.[31] For tax years beginning on or after January 1, 2008, a taxpayer may adopt a simplified method to claim 12.5 percent of taxable income derived from a foreign country as foreign tax credit upon the approval of the tax authority in charge. The per-country rule also applies to the simplified method.[32] To adopt the simplified method, the following conditions must be met:[33]

(1) The taxpayer can produce evidence issued by the foreign tax authority for payment of tax; however, the amount of tax paid cannot be accurately identified for objective reasons. This evidence refers to the valid evidence showing the amount of composite tax (including corporate income tax) that the taxpayer actually paid to the foreign government; and
(2) The effective tax rate at income source country is no less than 12.5 percent. This means that foreign tax credit will be the lesser of 12.5 percent and the amount shown on the tax payment evidence. The effective tax rate here is the amount of corporate income tax actually paid or borne divided by the taxable income of the tax payer.

This new deemed credit method does not allow an enterprise to mix foreign tax credit between low tax and high tax jurisdiction (other than the first-tier subsidiary mixer as discussed in Chapter 9.2.4), and requires the evidence of actual tax payment. As such, the method does not seem to provide any benefits to taxpayers. It seems that a taxpayer should only use the simplified method where it does not separately pay income tax and only pays a composite tax in a country. It is not clear whether an enterprise can adopt the simplified method for only one country and the regular method for other countries. Presumably, such country selection should be permitted.

The MOF and the SAT have identified some countries whose statutory tax rate is obviously higher than that of China. Where income derived from these countries and effective tax rate is obviously higher than the China statutory rate, which is 25 percent, the following formula can be used:[34]

$$\text{Foreign tax credit} = \text{Taxable income from foreign source} \times 25\%$$

[31] Provisional Measures on Computation and Collection of Income Derived from Outside China, Cai Shui Zi [1997] No. 116, issued by the MOF and the SAT on November 25, 1997.

[32] Article 31 of the FTC Operational Guidance.

[33] Article 10 of Cai Shui [2009] No. 125; Articles 32 and 33 of the FTC Operational Guidance.

[34] Article 10 of Cai Shui [2009] No. 125.

The countries listed on the initial list as an appendix to Cai Shui [2009] No. 125 are Argentina, Bangladesh, Burundi, Cameroon, Cuba, France, Japan, Jordan, Kuwait, Laos, Morocco, Pakistan, Syria, United States, and Zambia.

9.2.6 SPARING TAX CREDIT

Tax sparing refers to the practice of one treaty state allowing its taxpayers to claim a foreign tax credit for a tax in the other contracting state not actually paid. The purpose of sparing tax credit is to allow a developing country to offer tax incentives such as a tax holiday to attract foreign investments in the developing country.

For example, suppose that a China resident enterprise sets up a subsidiary in India. The subsidiary produces RMB100 of income that normally would be subject to income tax at 30 percent in India. Suppose that India grants a tax exemption for three years and the subsidiary pays RMB100 of dividends to the China resident enterprise (let's ignore withholding tax for illustration purpose). In the absence of tax sparing, the China resident enterprise would have to pay RMB25 of CIT (RMB100 of gross dividend x 25%). As such, the beneficiary of the Indian tax incentives would be the Chinese Government. The income tax treaty between China and India contains a tax-sparing provision which provides that the tax paid in a Contracting State for tax credit purpose shall be deemed to include the tax which would have been payable but for the legal provisions concerning tax reduction exemption or other tax incentives of the Contracting States for the promotion of economic development.[35] According to the tax-sparing provision of the treaty, China would allow a deemed foreign tax credit of RMB30. Assuming this is the only income derived from India, the credit limitation for the current year should be 25; the China resident would not need to pay any China CIT on the RMB100 of dividend.

The China-India treaty provides for mutual tax sparing. China tax treaties with some other developing countries such as Pakistan[36] and Vietnam[37] also contain a mutual tax-sparing provision. China tax treaties with many developed countries include a tax-sparing provision for the benefit of China only. Under those treaties, the contracting developed country will allow a deemed tax credit for the amount of Chinese tax which would have

[35] Article 23(3) of Agreement Between the Government of the Republic of India and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income.

[36] Article 24 of Agreement Between the Government of the Republic of the Islamic Republic of Pakistan and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income.

[37] Article 23(3) of Agreement Between the Government of the People's Republic of China and the Government of the Socialist Republic of Vietnam and for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income.

been paid if the Chinese tax had not been exempted, reduced, or refunded in accordance with certain tax incentive provisions of Chinese tax law.

A taxpayer cannot claim sparing tax credit if it adopts the simplified method to calculate foreign tax credit.[38] The simplified method is discussed in Chapter 9.2.5. If an enterprise derives an income from a foreign country and such income is not subject to income tax under the domestic law of the foreign country, but is taxable income under the CIT Law, then such income is not within the scope of tax-sparing credit, and the enterprise should pay full CIT on such income in accordance with the CIT Law.[39] Suppose P, a resident enterprise, owns a 100 percent subsidiary S in Country A. The tax treaty between China and Country A provides for a tax-sparing credit for tax incentives given by Country A for the promotion of economic development of Country A. S has taxable income of RMB100 comprising RMB80 from business operations and RMB20 of interest income. Country A's tax rate is 30 percent. Country A does not tax interest income. S's actual income tax in Country A is zero because of a tax holiday granted under the economic development promotion program of Country A. S pays its net profit of RMB100 to P. P's sparing tax credit is 24 (RMB80 income x 30% tax rate) subject to credit limitation. The sparing tax credit does not apply to the RMB20 interest income, which should be subject to CIT at 25 percent.

9.2.7 DOCUMENTATION FOR CLAIMING FOREIGN TAX CREDIT

When an enterprise claims a foreign tax credit, it should submit to the tax bureau in charge the following documents:[40]

(1) The certificate of foreign tax payment or other evidence of tax payment (original or copy).
(2) For claiming a foreign tax credit with respect to foreign branch income, the enterprise should provide (i) the financial statements of the foreign branch, (ii) a tax computation schedule prepared under the CIT Law and the CIT Implementation Rules and explanation, (iii) an audit report of the branch issued by qualified organization.
(3) For claiming a foreign tax credit with respect to foreign dividends, the enterprise should provide the organizational chart of the enterprise's group and the written decision of dividend distribution made by the authorized authority of the dividend paying foreign enterprise.

[38] Article 24 of the FTC Operational Guidance.
[39] Article 25 of the FTC Operational Guidance.
[40] Article 30 of the FTC Operational Guidance.

(4) For claiming a foreign tax credit with respect to foreign interest, rent, royalties, and gain on property transfer, the enterprise should provide a tax computation schedule prepared under the CIT Law and the CIT Implementation Rules and a copy of relevant contracts.
(5) For claiming a tax-sparing credit, the enterprise should provide (i) the basis and evidence of tax exemption or reduction granted to the enterprise or the foreign enterprises directly or indirectly controlled by the enterprise, or a copy of audit report showing the tax incentives enjoyed by the enterprise, (ii) the copy of evidence of direct or indirect ownership in the foreign enterprise, (iii) the computation of indirect credit or sparing credit, and (iv) the financial statements of foreign enterprise.
(6) For claiming a foreign tax credit under the simplified method, the enterprise should provide (i) an application and relevant information statement, and (ii) the certificate in the nature of tax payment proof issued by the relevant foreign government if the enterprise receives foreign branch income, or the evidence of qualified ownership in the foreign subsidiaries if the enterprise receives foreign dividends that are qualified for a foreign tax credit.

The tax authorities may request additional information. If any of the required documents is not in the Chinese language, the enterprise must provide a Chinese translation. The above documents only need to be provided once. However, if there is any change of information, the enterprise must re-provide the documents. If copies are provided, the enterprise must indicate in writing that the copies are identical to the originals and chop corporate stamp on the copies.

9.3 Controlled Foreign Corporation

If a China resident enterprise conducts business through foreign subsidiaries, the resident enterprise generally is not taxed on the profits of the foreign subsidiaries until distribution of dividends by the subsidiaries. To prevent resident enterprises from deferring China tax by accumulating profits of foreign operations or foreign investments in low tax jurisdictions, the CIT Law provides a controlled foreign corporation (CFC) provision.[41] A foreign enterprise is considered to be a CFC if (1) each of resident enterprises or resident individuals directly or indirectly owns 10 percent or more of a foreign enterprise's voting right and those resident enterprises and resident individuals directly or indirectly own an aggregate total of 50 percent or more of the voting rights of the foreign enterprise; or (2) although not satisfying (1), resident enterprises control the foreign enterprise

[41] Article 45 of the CIT Law.

via equity, financing, operations, or purchase and sales relation.[42] In computing the indirect ownership of a resident enterprise in a foreign enterprise, if an intermediate holding company owns 50 percent or more of a foreign enterprise, the intermediate holding company will be deemed to own 100 percent of the foreign enterprise.[43] For example, if a resident enterprise Resident Co owns 40 percent of Foreign Company A, which in turn owns 30 percent of Foreign Company B, Resident Co's indirect ownership in Foreign Company B will be 12 percent. However, if Foreign Company A owns 50 percent of Foreign Company B, then Foreign Company A will be deemed to own 100 percent of Foreign Company B for the purpose of determination of CFC; Resident Co will be deemed to own 40 percent of Foreign Company B.

A resident enterprise shareholder must include its share of undistributed CFC profits in its gross income if the actual effective tax burden in the CFC's jurisdiction is less than 12.5 percent and the CFC fails to distribute profits without reasonable business reasons.[44] This deemed dividend income is derived by a resident enterprise using the following formula:[45]

$$\begin{aligned}&\text{Deemed dividend in current period}\\&\quad= \text{Deemed dividend distribution} \times \text{Actual days of ownership of CFC}\\&\qquad\div \text{Days of the tax year for the CFC} \times \text{Percentage of ownership in CFC}\end{aligned}$$

The percent of ownership in CFC for indirect ownership is the product of percentage of ownership in each tier of subsidiary. In our above example, where Resident Co owns 40 percent of Foreign Company A which in turn owns 50 percent of Foreign Company B and if Foreign Company B is a CFC, the percentage of ownership of Resident Co in Foreign Company B will be 20 percent (40% x 50%) even though for purpose of determination of CFC, Resident Co is deemed to own 40 percent of Foreign Company B.

The income that is deemed to be distributed to a resident enterprise may carry with it an indirect foreign tax credit for any creditable income taxes paid by the CFC in foreign countries; the resident enterprise can claim a foreign tax credit in accordance with the CIT Law and applicable income tax treaty.[46] When the CFC subsequently distributes previously taxed income to the resident enterprise, there is no further CIT to the resident enterprise shareholder.[47] A resident enterprise shareholder does not need to

[42] Article 117 of the CIT Implementation Rules.

[43] Article 77 of Guo Shui Fa [2009] No. 2.

[44] Article 45 of the CIT Law; Article 118 of the CIT Implementation Rules.

[45] Article 80 of Guo Shui Fa [2009] No. 2.

[46] Article 82 of Guo Shui Fa [2009] No. 2.

[47] Article 83 of Guo Shui Fa [2009] No. 2.

treat its share of undistributed profits of a CFC as deemed dividend if it provides evidence to prove that the CFC satisfies one of the following conditions:[48]

(1) The CFC is established in a non-low tax rate jurisdiction that is designated by the SAT;
(2) The CFC's income is mainly from active business operations; or
(3) The annual profit of CFC is no more than RMB5 million.

According to item (2) above, the CFC provision seems to permit an operating CFC to keep active business profit overseas; the deemed distribution rules should only be applicable to passive income that a CFC receives. As such, the CFC rules should not affect a foreign operating subsidiary that actively conducts business operations in a foreign country. When the operating subsidiary distributes profits to a foreign holding company, the resident enterprise parent may need to include the dividend income of the foreign holding company in the parent's gross income. However, if the parent company can demonstrate that the non-repatriation of profits by the foreign holding company is for the business needs (e.g., investing in another operating subsidiary), the resident enterprise may not need to treat the undistributed profits as deemed dividends.

9.4 General Anti-Avoidance Provision

The tax authorities are empowered to make a special adjustment if an enterprise carries out business arrangements without reasonable business purposes, resulting in reduction of its taxable income.[49] "Without reasonable business purposes" refers to reducing, avoiding, or deferring paying taxes as primary purposes.[50] The Implementation Rules for Special Tax Adjustments provide administrative guidance concerning general anti-avoidance. According to the guidance, the tax authorities may initiate a general anti-avoidance audit to enterprises with tax avoidance arrangements, including: (1) abuse of tax incentive; (2) abuse of tax treaties; (3) abuse of a company's legal form; (4) tax avoidance through a tax haven; and (5) other arrangements without bona fide commercial purpose.[51]

When determining whether an enterprise has a tax avoidance arrangement, the tax authorities should carefully consider various factors based on the substance over form principle. Those factors include (1) the form and substance of the arrangement; (2) conclusion time and execution period of the arrangement; (3) the implementation method

[48] Article 84 of Guo Shui Fa [2009] No. 2.

[49] Article 47 of the CIT Law.

[50] Article 120 of the CIT Implementation Rules.

[51] Article 92 of Guo Shui Fa [2009] No. 2.

of the arrangement; (4) relationship between each step and part of the arrangement. (5) the changes in financial performance of each party involved in the arrangement; and (6) tax consequences of the arrangement.[52] The tax authorities may redefine the nature of a tax avoidance arrangement based on business substance, and revoke an enterprise's tax benefit obtained from the tax avoidance arrangement. The tax authorities may, for CIT purposes, disregard the existence of the enterprises without economic substance, particularly which are established in tax havens and result in tax avoidance of their related or unrelated parties.[53]

When the tax authorities start a general anti-avoidance audit, it will send a Notice on Tax Audit to the enterprise in accordance with the provisions of the Law of Administration of Tax Collection and the Implementation Rules for Law of Administration of Tax Collection. Within 60 days of receiving a notice, the enterprise should provide documents to prove its arrangement has a bona fide commercial purpose. If the enterprise does not provide the documents within the period or the documents cannot prove its arrangement has a bona fide commercial purpose, the tax authorities may send a Special Tax Audit Adjustment Notice to the enterprise and make a tax adjustment based on information already acquired.[54]

Law of Administration of Tax Collection authorizes the tax authorities to request information concerning a taxpayer from other entities or individuals when making an investigation of a taxpayer. The other entities and individuals are obligated to provide the tax authorities with true information and supporting documents concerning the tax payment of the taxpayer.[55] When the tax authorities start a general anti-avoidance audit, it may require the planner of the tax avoidance arrangement to provide relevant documents and materials in accordance with the Law of Administration of Tax Collection.[56] The tax regulations do not provide a definition regarding the planner of tax arrangement. Perhaps the planner would include entities and individuals within the enterprise or the enterprise group as well as outside the organization, such as professional service firms advising the enterprise on the arrangement. General anti-avoidance audits and adjustments must be reported level-by-level to the SAT for approval.[57]

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[52] Article 93 of Guo Shui Fa [2009] No. 2.

[53] Article 94 of Guo Shui Fa [2009] No. 2.

[54] Article 95 of Guo Shui Fa [2009] No. 2.

[55] Article 57 of the Law of Administration of Tax Collection.

[56] Article 96 of Guo Shui Fa [2009] No. 2.

[57] Article 97 of Guo Shui Fa [2009] No. 2.

10

INCOME TAX TREATIES

Income tax treaties are agreements composed of a set of mutual adjustments and concessions between the tax laws of two countries. Hong Kong and Macau are two special administrative regions of China. However, they are tax jurisdictions separate from the Mainland of China. The tax arrangements between the Mainland of China and those regions have the same nature as tax treaties. In this book, any general discussions of tax treaties will include such tax arrangements.

Income tax treaties are concerned in the main with double taxation. They generally determine the extent of taxation imposed by each of the treaty countries or regions on transactions affecting both countries or regions. Tax treaties mainly provide relief for double taxation in the form of reduction or exemption of taxation for residents of one country on certain types of income from the other. Tax treaties commonly also provide procedures for mutual agreement and information exchange between the treaty countries.

10.1 Legal Authority and Interpretations of Tax Treaties

The authority to approve treaties is vested in the Standing Committee of NPC.[1] The treaties between China and foreign countries have the same legal authority as domestic law.

[1] Article 67 of Constitution

The CIT Law specifically provides that where the provisions of a tax treaty are different from the provisions of the CIT Law, the provisions of the treaty will prevail.[2]

In spite of authority of provisions of tax treaties over those of the CIT Law, the interpretations of treaty provisions are often a challenge. The SAT sometimes issues tax circulars interpreting the eligibility and requirements for application of specific treaty provisions. Those interpretations may not necessarily be the same as those of treaty partners. One example of inconsistent treaty interpretations by treaty parties is to how to count a six-month period for the purpose of determining a permanent establishment under the tax arrangement between the Mainland of China and Hong Kong. The current tax arrangement came into effect in the Mainland of China on January 1, 2007. On April 4, 2007, the SAT issued Guo Shui Han [2007] No. 403, interpreting some provisions of the tax arrangement. With respect to a permanent establishment for provision of services, Article 5 of the tax arrangement then provided that a permanent establishment includes the furnishing of services by an enterprise from one party in the agreement to the other party for a period or periods aggregating more than six months within any twelve-month period. According to the SAT's interpretation in Guo Shui Han [2007] No. 403, where an enterprise of Hong Kong provides services for a particular project in the Mainland of China, the number of months between the month that an employee of the Hong Kong enterprise first arrives on the mainland to provide services on the project and the month that an employee finishes the project and leaves the mainland would be regarded as the number of months for the purpose of the six-month calculation. If there is a consecutive period of thirty days where no employee of the Hong Kong enterprise is in China for the project, one month may be deducted from the total. Hong Kong Inland Revenue Department had different interpretation of the same provision of the tax arrangement in Departmental Interpretation and Practice Notes No. 44. Hong Kong considered that the term "month" to be a period of thirty days. In counting whether a Mainland enterprise has furnished services in Hong Kong for a period or periods aggregating more than six months within any twelve-month period, Hong Kong would add together the time periods that services have been provided in Hong Kong by the Mainland enterprise directly or through its employees (irrespective of the length of the time period) within any twelve-month period. If the cumulative number of days during the time period within that twelve-month period exceeds 180 days, Hong Kong would consider that the Mainland enterprise has a permanent establishment in Hong Kong. Subsequently, the SAT and Hong Kong Inland Revenue Department signed the second protocol to the tax arrangement. According to the second protocol, Article 5 of the tax arrangement is amended to replace "6 months" with "183 days."

The consistent interpretation of Article 5 of the tax arrangement between the Mainland of China and Hong Kong concerning the time period for permanent establishment has

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[2] Article 58 of the CIT Law.

been achieved by amending the tax arrangement itself. Unfortunately, different views of treaty provisions from different treaty countries more often will not lead to similar solution. Many tax circulars concerning treaty application are not country specific. China may impose specific conditions for eligibility for certain type of treaty benefits (not benefits under one specific treaty). Treaty interpretations and implementation were a relevant weak area in China tax administration. There are not a lot of written authorities on treaty interpretations. The lack of experience of tax authorities in many local areas sometimes results in different interpretations in treaty applications. In recent years, especially since the effectiveness of the CIT Law on January 1, 2008, China has made significant efforts to strengthen the administration of treaty application. However, it appears that the focus is on anti-avoidance. Most recently circulars concerning tax treaties seem to make it more difficult for non-resident companies to obtain tax treaty benefits.

Commentaries have been written on the Organisation for Economic Co-operation and Development (OECD) Model Treaty's provisions that are very helpful in interpreting treaties. China is not a member of OECD, and OECD commentaries are not binding authorities. However, some SAT officials often look at OECD commentaries as a reference when giving their personal opinions in the interpretations of treaty provisions. Accordingly, OECD commentaries can be presented to support a position on the application of a treaty provision even though the tax authorities may not necessarily agree on such interpretations.

10.2 Treaty Network

In 1983, China concluded its first double taxation treaty with Japan. Since then, the number of income tax treaties and arrangements has increased such that China has agreements with 91 countries and regions as of October 31, 2010. The table below lists the countries that have concluded double taxation treaties and regions that have concluded tax arrangements with China as well as the status of those treaties and arrangements.

List of China Double Taxation Treaties Enforced

Country (region)	Signed on	Entered into force on	Applicable since
Albania	September 13, 2004	July 28, 2005	January 1, 2006
Algeria	November 6, 2006	July 27, 2007	January 1, 2008
Armenia	May 5, 1996	November 28, 1996	January 1, 1997
Australia	November 17, 1988	December 28, 1990	January 1, 1991
Austria	April 10, 1991	November 1, 1992	January 1, 1993
Azerbaijan	March 17, 2005	August 17, 2005	January 1, 2006
Bahrain	May 16, 2002	August 8, 2002	January 1, 2003

List of China Double Taxation Treaties Enforced (Continued)

Country (region)	Signed on	Entered into force on	Applicable since
Bangladesh	September 12, 1996	April 10, 1997	China: January 1, 1998 Bangladesh: July 1. 1998
Barbados	May 15, 2000	October 27, 2000	January 1, 2001
Belarus	January 17, 1995	October 3, 1996	January 1, 1997
Belgium	April 18, 1985	September 11, 1987	January 1, 1988
Brazil	August 5, 1991	January 6, 1993	January 1, 1994
Brunei	September 21, 2004	December 29, 2006	January 1, 2007
Bulgaria	November 6, 1989	May 25, 1990	January 1, 1991
Canada	May 12, 1986	December 29, 1986	January 1, 1987
Croatia	January 9, 1995	May 18, 2001	January 1, 2002
Cuba	April 13, 2001	October 17, 2003	January 1, 2004
Cyprus	October 25, 1990	October 5, 1991	January 1, 1992
Czech Republic[3]	June 11, 1987	December 23, 1987	January 1, 1988
Denmark	March 26, 1986	October 22, 1986	January 1, 1987
Egypt	August 13, 1997	March 24, 1999	January 1, 2000
Estonia	May 12, 1998	January 8, 1999	January 1, 2000
Finland	May 12, 1986	December 18, 1987	January 1, 1988
France	May 30, 1984	February 21, 1985	January 1, 1986
Georgia	June 22, 2005	November 10, 2005	January 1, 2006
Germany	June 10, 1985	May 14, 1986	Tax on interest and royalties: July 1, 1985 Others: January 1, 1985
Greece	June 3, 2002	November 1, 2005	January 1, 2006
Hong Kong SAR	August 21, 2006	December 8, 2006	Mainland: January 1, 2007 Hong Kong: April 1, 2007
Hungary	June 17, 1992	December 31, 1994	January 1, 1995
Iceland	June 3, 1996	February 5, 1997	January 1, 1998
India	July 18, 1994	November 19,1994	January 1, 1995

Continued

[3] The former Czechoslovak Socialist Republic is divided into Czech Republic and Slovak Republic. On December 18, 1992, Czech Republic notified China that they would assume the treaties between China and former Czechoslovak. According to Guo Shui Fa Zi [1993] No. 68, before the effectiveness of a new tax treaty, the residents of Czech Republic may enjoy treatments under the double taxation treaty between China and former Czechoslovak on a reciprocal basis. On August 28, 2009, China and Czech Republic signed an income tax treaty, which is pending for ratification.

List of China Double Taxation Treaties Enforced (Continued)

Country (region)	Signed on	Entered into force on	Applicable since
Indonesia	November 7, 2001	August 25, 2003	January 1, 2004
Iran	April 20, 2002	August 14, 2003	January 1, 2004
Ireland	April 19, 2000	December 29, 2000	China: January 1, 2001 Ireland: April 6. 2001
Israel	April 8, 1995	December 22, 1995	January 1, 1996
Italy	October 31, 1986	November 14, 1989	January 1, 1990
Jamaica	June 3, 1996	March 15, 1997	January 1, 1998
Japan	September 6, 1983	June 26, 1984	January 1, 1985
Kazakhstan	September 12, 2001	July 27, 2003	January 1, 2004
Korea, Rep. of	March 28, 1994	September 27, 1994	January 1, 1995
Kuwait	December 25, 1989	July 20, 1990	January 1, 1989
Kyrgyzstan	June 24, 2002	March 29, 2003	January 1, 2004
Laos	January 25, 1999	June 22, 1999	January 1, 2000
Latvia	June 7, 1996	January 27, 1997	January 1, 1998
Lithuania	June 3, 1996	October 18, 1996	January 1, 1997
Luxembourg	March 12, 1994	July 28, 1995	January 1, 1996
Macau SAR	December 27, 2003	December 30, 2003	January 1, 2004
Macedonia	June 9, 1997	November 29, 1997	January 1, 1998
Malaysia	November 23, 1985	September 14, 1986	January 1, 1987
Malta	February 2, 1993	March 20, 1994	January 1, 1995
Mauritius	August 1, 1994	May 4, 1995	January 1, 1996
Mexico	September 12, 2005	March 1, 2006	January 1, 2007
Moldova	June 7, 2000	May 26, 2001	January 1, 2002
Mongolia	August 26, 1991	June 23, 1992	January 1, 1993
Morocco	August 27, 2002	August 16, 2006	January 1, 2007
Netherlands	May 13, 1987	March 5, 1988	January 1, 1989
New Zealand	September 16, 1986	December 17, 1986	January 1, 1987
Nigeria	April 15, 2002	March 21, 2009	January 1, 2010
Norway	February 25, 1986	December 21, 1986	January 1, 1987
Oman	March 25, 2002	July 20, 2002	January 1, 2003
Pakistan	November 15, 1989	December 27, 1989	Pakistan: July 1, 1990 China: Withholding Tax January 1, 1990; others January 1, 1990
Papua New Guinea	July 14, 1994	August 16, 1995	January 1, 1996
Philippines	November 18, 1999	March 23, 2001	January 1, 2002

List of China Double Taxation Treaties Enforced (Continued)

Country (region)	Signed on	Entered into force on	Applicable since
Poland	June 7, 1988	January 7, 1989	January 1, 1990
Portugal	April 21, 1998	June 7, 2000	January 1, 2001
Qatar	April 2, 2001	October 21, 2008	January 1, 2009
Romania	January 16, 1991	March 5, 1992	January 1, 1993
Russia	May 27, 1994	April 10, 1997	January 1, 1998
Saudi Arabia	January 23, 2006	September 1, 2006	January 1, 2007
Seychelles	August 26, 1999	December 17, 1999	January 1, 2000
Singapore	July 11, 2007	September 18, 2007	January 1, 2008
Slovak Republic[4]	June 11, 1987	December 23, 1987	January 1, 1988
Slovenia	February 13, 1995	December 27, 1995	January 1, 1996
South Africa	April 25, 2000	January 7, 2001	January 1, 2002
Spain	November 22,1990	May 20. 1992	January 1, 1993
Sri Lanka	August 11, 2003	May 22, 2005	January 1, 2006
Sudan	May 30, 1997	February 9, 1999	January 1, 2000
Sweden	May 16, 1986	January 3, 1987	January 1, 1987
Switzerland	July 6, 1990	September 27, 1991	January 1, 1990
Tajikistan	August 27, 2008	March 28, 2009	January 1, 2010
Thailand	October 27, 1986	December 29, 1986	January 1, 1987
Trinidad and Tobago	September 18, 2003	May 22, 2005	Withholding tax: June 1, 2005 Others: January 1, 2006
Tunisia	April 16, 2002	September 23, 2003	January 1, 2004
Turkey	May 23, 1995	January 20, 1997	January 1, 1998
Ukraine	December 4, 1995	October 18, 1996	China: January 1, 1997 Ukraine: CIT - January 1; other taxes - December 17, 1996
United Arab Emirates	July 1, 1993	July 14, 1994	January 1, 1995
United Kingdom	July 26, 1984	December 23, 1984	January 1, 1985
United States	April 30, 1984	November 21, 1986	January 1, 1987

Continued

[4] The former Czechoslovak Socialist Republic is divided into Czech Republic and Slovak Republic. On December 18, 1992, Slovak Republic notified China that they would assume the treaties between China and former Czechoslovak. According to Guo Shui Fa Zi [1993] No. 68, before the effectiveness of a new tax treaty, the residents of Slovak Republic may enjoy treatments under the double taxation treaty between China and former Czechoslovak on a reciprocal basis.

List of China Double Taxation Treaties Enforced (Continued)

Country (region)	Signed on	Entered into force on	Applicable since
Uzbekistan	July 3, 1996	July 3, 1996	January 1, 1997
Venezuela	April 17, 2001	December 23, 2004	January 1, 2005
Vietnam	May 17, 1995	October 18, 1996	January 1, 1997
Yugoslavia[5]	March 21, 1997	January 1, 1998	January 1, 1998

(Sources: SAT).

China and Nepal signed a double taxation treaty on May 14, 2001. As of October 31, 2010, the treaty is still pending approval by both countries.

10.3 Resident

The bases of taxing power over an enterprise by a country under domestic laws are often the residence of the enterprise as well as the source of the income received. Where activities of an enterprise involve two countries, both countries may have the right to tax the income derived from such activities under domestic laws of the countries. To eliminate double taxation, one country may give up some of the taxes it would otherwise impose on income derived by residents of another country under a tax treaty. As such, residence is a crucial provision of a tax treaty that determines whether an enterprise is entitled to treaty benefits extended by other country.

Most China tax treaties include the following paragraph with respect to resident of an enterprise:

> For the purposes of this Agreement, the term "resident of a Contracting State" means any person who, under the laws of that Contracting State, is liable to tax therein by reason of his domicile, residence, place of head office, place of management or any other criterion of a similar nature.

"Liable to tax" does not mean "pay tax." A person may be considered liable to tax even if the country does not in fact impose tax. For example, foundations or charitable organizations may be exempted from tax in a country, but they are exempt only if they meet all of the requirements for exemption specified in the tax laws. They are, thus, subject to the

[5] The double taxation treaty is between China and former the Federal Republic of Yugoslavia, which consisted of the former Socialist Republic of Serbia and Socialist Republic of Montenegro. On February 4, 2003, former the Federal Republic of Yugoslavia was replaced by former Serbia and Montenegro. On June 3, 2006, Montenegro declared its independence. There is no tax treaty signed between China and Montenegro and Serbia.

tax laws of a country. China generally will consider them liable to tax and therefore residents for tax treaty purposes.[6] As an exception, "liable to tax" is not expressly stated as a requirement for a Hong Kong resident under the tax arrangement between the Mainland of China and Hong Kong. According to the tax arrangement, a resident of Hong Kong includes any legal entity incorporated in the Hong Kong Special Administration Region, or outside of the Hong Kong Special Administration region but with the administration and control activities in Hong Kong.[7]

Whether an enterprise is a tax resident of a country or region is determined by the law of that country or region. To apply for benefits in China under a double tax treaty, an applicant should prove that taxpayer is a resident of the applicable treaty country or region. The applicant generally is required to provide a resident certificate issued by the competent authority of the treaty country or region. The SAT collects, updates, and forwards the samples of resident certificates of treaty countries and regions to local tax authorities from time to time. If a local tax authority finds the resident certificate provided by an applicant different from the sample, or otherwise has any doubt, the local tax authority is required to confirm the information through the SAT.[8] A taxpayer that is certified as a resident of a treaty country by the competent authority of the country may not necessarily entitle the taxpayer to the tax benefits in China under the tax treaty. Under the definition of residence in most treaties, and under applicable domestic tax laws, it would be possible for an enterprise to be considered as resident of more than one country. For example, a company can be considered a resident of a foreign country by reason of incorporation under the law of that foreign country. The company may also be considered as a resident enterprise of China by the reason of place of effective management in China. Where a taxpayer is considered a resident of both a foreign country and China, the tie-breaking rule provided in the tax treaty should apply. Many China treaties provide that if an enterprise is a resident in both contracting states, the enterprise will be deemed to be a resident only in the place of effective management or the place of head office; while other treaties would require a mutual agreement to solve the conflict.

If a resident enterprise of Country A has an establishment in Country B, China will not consider the establishment as resident of Country B, rather the establishment is part of resident of Country A and the treaty between China and Country A should apply.

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[6] Article 4(1) the Interpretations of Provisions of Agreement between the Government of the People's Republic of China and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Its Protocols, issued via Guo Shui Fa [2101] No. 75 and issued by the SAT on July 26, 2010.

[7] Article 4(1)(b)(3) of Agreement between the Mainland of China and the Hong Kong Special Administration Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income.

[8] The Notice on Printing the Samples of Resident Certificates of Some Countries and Regions, Guo Shui Han [2009] No. 395, issued by the SAT on July 24, 2009.

If Country A does not have a tax treaty with China, domestic law (rather than the tax treaty between China and Country B) will apply.[9]

A difficult question arises in applying tax treaties to partnerships. The CIT Law does not apply to domestic partnerships.[10] A domestic partnership is not a taxpayer; rather each partner of a partnership is a taxpayer.[11] The fiscally transparent treatment does not apply to a foreign partnership. Where a foreign partnership conducts business in China, the partnership in practice often is treated as corporation for CIT purposes; the foreign partnership, rather than each partner, is subject to CIT in China. If a foreign country treats a partnership as a taxable entity and the partnership is a resident of the foreign country, the foreign partnership should be entitled to the benefits under the tax treaty between China and the foreign country. However, if a foreign partnership is not "liable to tax" and is treated as fiscally transparent by the foreign country, the foreign partnership most likely will not be able to produce a resident certificate of that country. In such a situation, it is most likely that the partnership will not be able to avail of the treaty benefit. It is not clear under the existing tax rule where a foreign partnership is fiscally transparent under the treaty country law, whether partners of the partnership are entitled to the treaty benefits. Furthermore, it is not clear that if a partnership is formed in a treaty country A and a partner of the partnership is a resident of treaty country B, whether the treaty between China and country B is applicable to the partner.

10.4 Beneficial Owner

To be eligible for some treaty benefits, a taxpayer not only must be a resident of the treaty country, but also must be a "beneficial owner" of the income items. The "beneficial owner" requirement typically is only applicable to the recipient who is the beneficial owner of the dividends, interest, or royalties.

On October 27, 2009, the SAT issued a circular[12] that provides guidelines for determination of a "beneficial owner" in the application of those tax treaty provisions. According to the circular, a "beneficial owner" is a person who has ownership of and control over an income or the rights and assets generating the income. A beneficial owner, which can be an individual, a company, or any other group, is generally engaged in substantial business activities. An agent or a conduit company is not a beneficial owner. The circular defines a "conduit company" as a company that is set up for the purpose of the avoidance or

9 Article 4(1) of Guo Shui Fa [2101] No. 75.

10 Article 1 of the CIT Law.

11 Article 1 of Cai Shui [2008] No. 159.

12 Notice on Interpretation and Determination of "Beneficial Owner" under Tax Treaties, Guo Shui Han [2009] No. 601, issued by the SAT on October 27, 2009.

reduction of tax, or the transfer or accumulation of profits. This type of company merely registers in a country in order to satisfy a legally required organization form; it does not conduct substantial business activities such as production, trading, and management. In determining the status of a "beneficial owner," the term should not be understood merely from the perspectives of technical sense or domestic law; rather, the status should be determined in its context and in light of the object and purposes of the tax treaty (i.e., avoiding double taxation and the prevention of fiscal evasion and avoidance) and based on the principle of substance over form and the analysis of actual facts and circumstances. The SAT lists the following factors, which are not in favor of positive determination of a "beneficial owner":

(1) The applicant is obligated to pay or distribute the income in full or a majority portion thereof (e.g., 60 percent or more) to residents of a third country or region within a prescribed time period (e.g., within 12 months after receiving the income);
(2) The applicant has no or almost no business activities other than holding the rights or assets that generate the income;
(3) If the applicant is a company, the assets, operation scale, and personnel of the applicant are small in size or amount, which does not match the amount of income;
(4) The applicant has no or almost no right to control or dispose of the income or the rights or assets generating the income and assumes no or little risk;
(5) The contracting country (region) does not tax the income, or the effective tax rate is very low;
(6) The lender to a loan agreement that generates interest income has another loan agreement or deposit contract with a third party; the amount, interest rate, and the time of conclusion with respect to the third-party contract is similar to those of the first loan agreement; and
(7) The licensor to an agreement on copyright, patent, and technology licensing or transfer has a contract to license or transfer those from a third party.

When a taxpayer applies for tax relief under a treaty, it should provide the information relevant to the factors listed above that proves that it is a beneficial owner. The tax authorities should determine whether the applicant is a beneficial owner by analyzing the above factors relevant to the income. If necessary, they may confirm the information relevant to the identification of a beneficial owner through information exchange with a treaty country.

The above interpretation of "beneficial owner" is part of China's effort to crack down on treaty shopping by non-resident enterprises. The enforcement of the rule will make it very difficult for multinational companies to enjoy the China treaty benefit merely by setting up a holding company in a favorable treaty country or region. However, it is not

clear whether, in the case where a non-resident enterprise is not a "beneficial owner" of income, the tax authorities will adopt a look-through approach to the shareholders of the conduit company. If so, the authorities would apply the applicable tax treaty to the shareholders, or they might simply treat the non-resident enterprise as a non-treaty country resident. The withholding tax rate on dividends, interest, and royalty derived by a non-resident enterprise under China domestic law and regulations currently is 10 percent, which is the same as the rate limitation under many China tax treaties. When a lower treaty rate is denied because of a conduit company, the result most likely will be the same regardless of whether the beneficial owner is a resident of a country that has a tax treaty providing 10 percent withholding tax rate limitation or that has no treaty with China. As such, this issue is rarely tested in practice.

10.5 Permanent Establishment

The main use of the concept of a permanent establishment is to determine the right of a contracting State to tax the business profits of an enterprise of another contracting State. Under China tax treaties, China cannot tax the profits of an enterprise of a treaty country unless the enterprise carries on its business through a permanent establishment in China.

10.5.1 Definition

A "permanent establishment" in China under China tax treaties is a fixed place of business through which the business of an enterprise of a treaty country is wholly or partly carried out, including (1) a place of management; (2) a branch; (3) an office; (4) a factory; (5) a workshop; and (6) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources. In interpreting Article 5 of the China-Singapore tax treaty, the SAT sets forth the following characteristics of a permanent establishment:[13]

(1) There must be a place of business. There is no limitation on size and scope (e.g., machine, storage, or stall) in this regard. The place can be owned or rented and can be used for one or more purposes. It can be a corner of a market, a part of a long-term rented warehouse, or it can be a space within another enterprise. As long as there is a space at the enterprise's disposal, the place is a place of business of the enterprise.

[13] Article 5(1) of Guo Shui Fa [2010] No. 75.

(2) The place of business must be "fixed" with a certain degree of permanence in time. A fixed place of business includes a fixed place for registered business such as an office or branch. It also includes an office used for provision of services in a contracting country such as a hotel room rented for a long term. "Fixed" is relative to other areas. For example, if an office rents different rooms (i.e., no one fixed room) in a hotel, the hotel can be treated as a fixed place. The fixed place of business must be relatively permanent, rather than temporary, in time. However, a temporary interruption or pause of business should not affect the permanent nature. Furthermore, if a place of business is established for a temporary purpose and if the place actually exists for a period of time beyond temporary, such place can retroactively constitute a permanent establishment. On the other hand, if a place of business is set up as permanent, but it actually exists for only a short period of time due to special reasons (e.g., early liquidation due to failure of investment), the place can be considered as a permanent establishment from its inception.

(3) The enterprise must carry on its business, wholly or partly, through the place of business. The "business" includes not only production and operation activities, but also the activities of non-profit organizations. The carrying on of business "through" the place of business is broadly interpreted. If a foreign enterprise signs contracts with customers in China and the contracts are performed by a place of business in China, the foreign enterprise is considered carrying on business through the place. Furthermore, if the place makes substantial contributions to the customer relationship between a foreign enterprise and a Chinese enterprise, the foreign enterprise can also be considered carrying on business through the place even if the contract is signed by the two enterprises directly.

10.5.2 WORK SITE OF CONSTRUCTION, ASSEMBLY, AND INSTALLATION

A permanent establishment includes a building site, a construction, assembly or installation project, or supervisory activities in connection therewith, but only where such site, project, or activities continue for a period of time as specified in a tax treaty, commonly six months within any twelve-month period. The determination of permanent establishment for this type of engineering activity is only based on the time period prescribed in the applicable tax treaty. The time period is computed starting from the first day of implementation of a contract (including preparation work) and ending on the date that the work (including trial operation) is complete and the project is delivered for service. If those activities continue for more than the time specified in the tax treaty, the activities should constitute a permanent establishment of the enterprise in China. The supervisory activities in connection with construction, assembly, or installation projects

include a general contractor's supervisory work with respect to work performed by a subcontractor as well as the supervisory work performed by an independent project supervision enterprise. The time period for the general contractor's supervisory activities is the same as the whole project. The independent supervisory work is treated as a separate project in counting the time period for permanent establishment purpose. If a foreign enterprise undertakes two or more projects at one work site in China (i.e., those projects commercially or geographically constitute an integrated part of one whole project), the time period for each project should not be separately counted, rather the period should start from the commencement of the first project and end on the completion of the last project. The time for construction site, engineering project, and relevant supervisory work should be counted on a continuing basis; the time of pause of work (e.g., due to the lack of equipment and materials or bad weather) should not be subtracted in computing the time period. If a main contractor subcontracts part of work to a subcontractor, the time of the subcontractor should be treated as part of the time for the main contractor in determining whether the main contractor has a permanent establishment in China. Such time inclusion will not affect separate determination of permanent establishment of the subcontractor with respect to the work performed by the subcontractor.[14]

10.5.3 PROVISION OF SERVICES

A permanent establishment includes the furnishing of services, including consultancy services, by a foreign enterprise through employees or other personnel engaged by the foreign enterprise for such purpose, but usually only where such activities continue within China for a certain period of time. The "other personnel engaged by a foreign enterprise" refers to the individuals who are engaged by the enterprise and perform services under the control and direction of the enterprise.[15] The "services" here refer to professional services such as engineering, technical, management, design, training, and consulting, including, for example: (1) the technical supervision, assistance, and consulting services for the implementation of an engineering project (not including specific implementation and operations); (2) the provision of services in relation to use and improvement of technology, management processes, project feasibility study, and selection of designed plan; and (3) the professional services in the operations and management of enterprises.[16] The time threshold for a permanent establishment for this type of services varies in

[14] Article 5(3)(i) of Guo Shui Fa [2010] No. 75.

[15] Article 5(3)(ii)(1) of Guo Shui Fa [2010] No. 75.

[16] Article 5(3)(ii)(2) of Guo Shui Fa [2010] No. 75.

different tax treaties. The table below summarizes those specific periods provided in China tax treaties:

For a period or periods aggregating more than	Country or Region
6 months	Kuwait
6 months within any 12 month period	Australia, Austria, Azerbaijan, Bangladesh, Barbados, Belgium, Brazil, Brunei, Bulgaria, Canada, Czech Republic, Slovak Republic, Denmark, France, Germany, Iceland, Indonesia, Italy, Japan, Korea, Luxembourg, Malaysia, Morocco, Netherlands, New Zealand, Norway, Papua New Guinea, Philippines, Poland, Portugal, Romania, Saudi Arabia, Spain, Sweden, Switzerland, Trinidad and Tobago, United States, and Vietnam
183 days	India
183 days within any 12-month period	Finland, Hong Kong SAR, Macau SAR, Singapore, Sri Lanka, Tajikistan, and Thailand
8 months	Malta
9 months	Oman
9 months within any 12-month period	Albania
12 months	Armenia, Hungary, Kazakhstan, Kyrgyzstan, Slovenia, and Turkey
12 months within any 24-month period	Croatia, Cuba, Cyprus, Egypt, Israel, Jamaica, Mauritius, Seychelles, South Africa, and Sudan
18 months	Belarus, Mongolia, Russia, and Ukraine
24 months	United Arab Emirates
Not specified	Algeria, Bahrain, Estonia, Georgia, Greece, Iran, Ireland, Laos, Latvia, Lithuania, Macedonia, Mexico, Moldova, Nigeria, Pakistan, Qatar, Tunisia, United Kingdom, Uzbekistan, Venezuela, and Yugoslavia

When counting the months or days for such determination of permanent establishment under this treaty provision, the activity period or periods during a testing period for the same project or a connected project should be aggregated. If an enterprise undertakes several projects that are commercially related and continued, these projects are treated as

"connected." Whether projects are connected depends on the facts and circumstances. The following factors should be considered:[17]

(1) Whether those projects are included in a master contract.
(2) If those projects are covered by different contracts, whether those contracts are signed by the same or related enterprises; whether the implementation of the first project is the prerequisite condition for the implementation of the second project.
(3) Whether the nature of those projects is the same.
(4) Whether those projects are performed by the same people.

Once the activity continues for more than the period specified in a tax treaty, the whole project is a permanent establishment. For example, the China-Singapore tax treaty provides for 183 days within any 12-month period. Suppose a Singapore company undertakes a consulting project in China for several years and its employees visit China from time to time. If the employees stay in China for more than 183 days in a 12-month period, the whole project is a permanent establishment even if the stay of the company's employees is no more than 183 days in any other 12-month periods.[18]

10.5.4 PREPARATORY AND AUXILIARY ACTIVITIES

The tax treaties usually exclude the following activities from permanent establishment:

(1) The use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the foreign enterprise;
(2) The maintenance of a stock of goods or merchandise belonging to the foreign enterprise solely for the purpose of storage, display or delivery;
(3) The maintenance of a stock of goods or merchandise belonging to the foreign enterprise solely for the purpose of processing by another enterprise;
(4) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the foreign enterprise;
(5) The maintenance of a fixed place of business solely for the purpose of carrying on, for the foreign enterprise, any other activity of a preparatory or auxiliary character;
(6) The maintenance of a fixed place of business solely for any combination of the activities mentioned in sub-paragraphs (1) through (5), provided that the

[17] Article 5(3)(ii)(3) of Guo Shui Fa [2010] No. 75.
[18] Article 5(3)(ii)(4) of Guo Shui Fa [2010] No. 75.

overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

The activities of "preparatory or auxiliary" usually have the following characters:[19]

(1) No independent business activities are performed in the place; the activities performed do not constitute essential part of the enterprise's business activities as a whole.
(2) The activities are only those listed in the treaty provision and are performed only for the enterprise and not for any other enterprises.
(3) The responsibility is limited to the nature of routine services and does not include the function of directly generating business profits.

In some situations, even if a place meets the above "preparatory or auxiliary" requirement in form, the tax authorities may consider the place as a permanent establishment based on its business substance. In interpreting the China-Singapore tax treaty, the SAT lists the following situations as examples:[20]

(1) A Singapore company's main business is to provide procurement services to its customers; the company charges fees for such services. The company has a representative office in China solely for the purpose of purchasing goods for the company. Because the nature of activities of the representative office is the same as the business of the company's headquarters in Singapore, the activities of the representative office are not preparatory or auxiliary.
(2) A Singapore company established a fixed place in China for the repairs and maintenance of equipment sold to its customers in China or the delivery of parts to its customers in China. As the activities in China are essential part of services provided by the company to its customers, those activities are not preparatory or auxiliary.
(3) A Singapore company established a representative office in China for business promotion activities. The promotion activities are not only for the company itself but also for other enterprises. In this situation, the activities of the representative office are not preparatory or auxiliary.

Additionally, where the activities carried through a place of business include both preparatory and auxiliary activities that do not constitute a permanent establishment and other activities which constitute a permanent establishment, the place is a permanent

[19] Article 5(4) of Guo Shui Fa [2010] No. 75.

[20] Article 5(4) of Guo Shui Fa [2010] No. 75.

establishment and CIT will be imposed on the combined income from both types of activities.

10.5.5 CONCLUDE CONTRACTS BY NON-INDEPENDENT AGENT

Where a person, other than an independent agent, is acting on behalf of a foreign enterprise from a treaty country and has exercised and habitually exercises in China, an authority to conclude contracts in the name of the foreign enterprise, that foreign enterprise will be deemed to have a permanent establishment in China with respect to any activities that person undertakes for the foreign enterprise, unless the activities of such person are limited to those of the preparatory or auxiliary nature specified in the tax treaty.

A non-independent agent can be an individual, an office, a company, or any other form of organization. Such non-independent agent is not necessarily an employee or division of the enterprise. It does not need a formal authorization from the enterprise. It is not necessarily a resident of China; it does not have to have a place of business in China. The "authority to conclude contracts in the name of the enterprise" includes not only signing contracts in the name of the enterprise but also the conclusion of contracts that are binding on the enterprise even if those contracts are not actually in the name of the enterprise. The "authority to conclude contracts" covers not only signing contracts but also a participation in negotiation of contract terms. As such, if an agent has negotiated detailed contract terms in China and those terms are binding the enterprise, the agent is considered as exercising the authority to conclude contracts even if the contract itself is actually signed in another country. However, contracts must be those related to the business of enterprise. If an agent enters into only the contracts concerning internal affairs of the enterprise, the authority to conclude those contracts alone should not constitute a permanent establishment of the enterprise. For example, an agent hires employees in the name of the enterprise to assist the agent in serving the enterprise; such activities alone would not constitute a permanent establishment. There is no uniform standard for "habitually exercise"; the determination of "habitually exercises" depends on the nature of the contracts, the business of the enterprise, and the frequency of exercising the authority by the agent. In some situations, because of the nature of business, the enterprise may not have a large number of transactions, but concluding a contract may need substantial time, such as sale of aircraft, ship, or other high value products. If an agent finds a buyer in China for this type of enterprise, and participates in sale contract negotiations, his conclusion of only one contract should be sufficient to constitute "habitually exercises."[21]

[21] Article 5(5) of Guo Shui Fa [2010] No. 75.

10.5.6 INDEPENDENT AGENT

An enterprise of a treaty country will not be deemed to have a permanent establishment in China merely because it carries on business in China through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, he will not be considered an agent of an independent status in determining the permanent establishment of the foreign enterprise in China if it is shown that the transactions between the agent and the foreign enterprise were not made under arm's-length conditions.

In order not to constitute a permanent establishment of a principal enterprise, an independent agent must satisfy two conditions.[22]

The first condition is that the agent must be independent of the enterprise both legally and economically. In determining this independency, the tax authorities will consider the following factors:

(1) The independence of commercial activities of the agent. Where the agent's commercial actives for the enterprise are subject to detailed instructions or to comprehensive control by the enterprise, such agent generally cannot be regarded as independent of the enterprise.
(2) Who bears the risk of the commercial activities performed by the agent? If such risk is borne by the enterprise and not by the agent, the agent generally cannot be regarded as independent.
(3) Number of principals represented by the agent. If the activities of agent are performed wholly or almost wholly on behalf of only one enterprise over a relevant long period of time, it is likely that the agent is not independent.
(4) The degree of reliance of the enterprise on special skill and knowledge of the agent. Generally speaking, an independent agent has special skill and knowledge to conduct commercial activities independently, and does not rely on the assistance of the enterprise. On the contrary, the enterprise usually uses the special skill and knowledge of the agent to expand its business or sell its products.

The second condition is that the agent must act in the ordinary course of its business, rather than conduting the business commercially belong to the enterprise, when acting on behalf of the enterprise. For example, a commission agent sells the goods or merchandise of the enterprise in its own name; such sale is the ordinary course of a commission

[22] Article 5(6) of Guo Shui Fa [2010] No. 75.

agent business. However, if the agent also habitually acts as an agent who has the authority to conclude contracts on behalf of the enterprise and those activities are beyond the ordinary course of its commission agent business, the agent will not be regarded as independent agent.

10.5.7 RELATIONSHIP BETWEEN PARENT AND SUBSIDIARY

China tax treaties generally recognize that the existence of a subsidiary company does not, in and of itself, constitute that subsidiary a permanent establishment of its parent company. For the purpose of taxation, such a subsidiary constitutes an independent legal entity. Even the fact that the trade or business carried on by the subsidiary is managed by the parent company does not constitute the subsidiary a permanent establishment of the parent. However, due to the existence of a special relationship between the parent and subsidiary in economic activities, there are complicated business and personnel exchanges between the parent and subsidiary. In such situations, in determining whether the activities of a parent company in its subsidiary constitute a permanent establishment of the parent in the subsidiary's country, the tax authorities will look at the following areas:[23]

(1) At the request of the subsidiary company, the parent company seconds personnel to the subsidiary. Those personnel are employed by the subsidiary. The subsidiary has control over the work of those employees. The parent company is not responsible for the work of the employees and the risk involved; those responsibilities and risks are borne by the subsidiary company. In those circumstances, the activities of those people should not constitute a permanent establishment of the parent company in the subsidiary's country; the compensation to those secondees, regardless of whether they are paid by the subsidiary directly or via the parent company, should be deductible expenses for the subsidiary.

(2) Where the parent company assigns its personnel to its subsidiary, and the personnel are working for the parent company, it should be determined whether the activities of the personnel constitute a permanent establishment of the parent in the subsidiary's country according to the criteria discussed in Chapter 10.5.1 - 10.5.3. The assignees may be considered working for the parent company if one of the following conditions is met:

  (i) The parent company has control over those people and bears risk and responsibility;

  (ii) The number of people and qualifications are decided by the parent company;

[23] Article 5(7) of Guo Shui Fa [2010] No. 75.

(iii) The compensation to those people are borne by the parent company; or
(iv) The parent earns profits by sending those people to work at the subsidiary.

In such situations, when the subsidiary pays service fees to the parent, the subsidiary may deduct such as expenses only after a determination that the fees are reasonable according the arm's-length principle. If the activities constitute a permanent establishment of the parent company in the subsidiary country, the parent company should be subject to CIT on the service fee received from the subsidiary in the subsidiary country.

(3) If the subsidiary has exercised and habitually exercises an authority to conclude contracts in the name of the parent company, and the subsidiary satisfies the conditions of non-independent agent, the subsidiary will constitutes a permanent establishment of the parent company.

10.6 Dividends, Interest, and Royalties

China tax treaties generally give the right of both China and the other contracting country to tax dividends, interest, and royalties paid by a Chinese enterprise to a resident of the contracting country. This potential double taxation is eliminated or mitigated through the agreed limitation of withholding tax rate as provide in the treaty articles concerning dividends, interest, and royalties and the treaty article on elimination of double taxation. The following table summarizes the withholding tax rate limitation on dividends, interest, and royalties paid or payable to a resident of another country who is a beneficial owner of such income. The treaty rate should be read as a limitation rather than an actual rate. Currently, withholding tax rate on the income derived by a non-resident enterprise that is not connected with a permanent establishment of the non-resident enterprise in China is 10 percent. As such, if the treaty rate is higher than 10 percent, this domestic rate should be applicable to dividends, interest, and royalties paid by a China resident enterprise to a resident of the treaty country

Treaty Withholding Tax Rates

Country (region)	Dividends %	Interest %	Royalties %
Albania	10	10	10
Algeria	10, 5	7	10
Armenia	10, 5	10	10

Continued

Treaty Withholding Tax Rates (Continued)

Country (region)	Dividends %	Interest %	Royalties %
Australia	15	10	10
Austria	10, 7	10, 7	10, 6
Azerbaijan	10	10	10
Bahrain	5	10	10
Bangladesh	10	10	10
Barbados	10, 5	10	10
Belarus	10	10	10
Belgium	10	10	10, 6
Brazil	15	15	25, 15
Brunei	5	10	10
Bulgaria	10	10	10, 7
Canada	15, 10	10	10
Croatia	5	10	10
Cuba	10, 5	7.5	5
Cyprus	10	10	10
Czechoslovakia	10	10	10
Denmark	10	10	10, 7
Egypt	8	10	8
Estonia	10, 5	10	10
Finland	10, 5	10	10, 7
France	10	10	10, 6
Georgia	10, 5, 0	10	5
Germany	10	10	10, 7
Greece	10, 5	10	10
Hong Kong SAR	10, 5	7	7
Hungary	10	10	10
Iceland	10, 5	10	10, 7
India	10	10	10
Indonesia	10	10	10
Iran	10	10	10
Ireland	10, 5	10	10, 6
Israel	10	10, 7	10, 7
Italy	10	10	10, 7
Jamaica	5	7.5	10
Japan	10	10	10
Kazakhstan	10	10	10

Treaty Withholding Tax Rates (Continued)

Country (region)	Dividends %	Interest %	Royalties %
Korea, Republic of	10, 5	10	10
Kuwait	5	5	10
Kyrgyzstan	10	10	10
Laos	5	5 (in Laos) 10(in China)	5 (in Laos) 10(in China)
Latvia	10, 5	10	10
Lithuania	10, 5	10	10
Luxembourg	10, 5	10	10, 6
Macau SAR	10	10, 7	10
Macedonia	5	10	10
Malaysia	10	10	15, 10
Malta[24]	10	10	10
Mauritius	5	10	10
Mexico	5	10	10
Moldova	10, 5	10	10
Mongolia	5	10	10
Morocco	10	10	10
Netherlands	10	10	10,6
New Zealand	15	10	10
Nigeria	7.5	7.5	7.5
Norway	15	10	10
Oman	5	10	10
Pakistan	10	10	12.5
Papua New Guinea	15	10	10
Philippines	15, 10	10	15, 10
Poland	10	10	10,7
Portugal	10	10	10
Qatar	10	10	10
Romania	10	10	7
Russia	10	10	10

Continued

[24] China and Malta signed a new double taxation treaty on October 22, 2010. The full text of the treaty has not been released to the public at the time of completion of manuscript of this book. According to Worldwide Tax Daily, October 26, 2010, under the new treaty, withholding tax rate on dividends paid by a Chinese company to a Malta resident who owns at least 25 percent of the Chinese company will be reduced to 5 percent and withholding tax rate on royalties will be reduced to 7 percent. http://services.taxanalists.com.

Treaty Withholding Tax Rates (Continued)

Country (region)	Dividends %	Interest %	Royalties %
Saudi Arabia	5	10	10
Seychelles	5	10	10
Singapore	10, 5	10, 7	10, 6
Slovak Republic	10	10	10
Slovenia	5	10	10
South Africa	5	10	10, 7
Spain	10	10	10, 6
Sri Lanka	10	10	10
Sudan	5	10	10
Sweden	10, 5	10	10, 7
Switzerland	10	10	10, 6
Tajikistan	10, 5	8	8
Thailand	20,15	10	15
Trinidad and Tobago	10, 5	10	10
Tunisia	8	10	10, 5
Turkey	10	10	10
Ukraine	10, 5	10	10
United Arab Emirates	7	7	10
United Kingdom.	10	10	10, 7
United States	10	10	10, 7
Uzbekistan	10	10	10
Venezuela	10, 5	10, 5	10
Vietnam	10	10	10
Yugoslavia	5	10	10

[a] Treaties commonly provide for a tax exemption on interest paid to government and certain institutions designated by government. 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.
[c] The lower rate applies to dividends paid by a company and received by a company owning at least 25 percent of the capital or voting right, or shareholding of the paying company. Reference should be made to the individual tax treaties.
[d] 0 percent applies to dividends paid by a company (not a partnership) and received by a company owning at least 50 percent of the shareholding of the paying company or investment amounting to EUR2 million; 5 percent applies to dividends paid by a company (not a partnership) and received by a company owning at least 10 percent of the shareholding of the paying company or investment amounting to EUR100,000.
[e] The lower rate applies where the beneficial owner of the dividend is a company that owns at least 10 percent of capital, voting stock, or shareholding of the paying company. Reference should be made to the individual tax treaties.
[f] The lower rate applies to interest paid to banks or financial institutions.
[g] The higher rate applies to trademarks.
[h] The higher rate applies to royalties for copyright of literary or artistic work including cinematography, films, or tapes for radio or television broadcasting.
[i] The lower rate applies to technical or economic studies or for technical assistance.

A number of tax treaties provide a lower withholding tax rate such as five percent on dividends. Under some of those treaties, the lower withholding tax rate is available to the beneficial owner of dividends where the beneficial owner directly holds at least certain percentage (usually 25 percent or 10 percent) of capital of the company paying dividends. In this situation, (1) the beneficial owner must be a company, (2) the percentage ownership of capital is the direct ownership of both equity and voting right of a resident company, and (3) such company must own such required percentage of ownership all the time during a consecutive 12-month period prior to a dividend date.[25] Such dividend date is the date that tax liability or withholding tax obligation arises under domestic law. If the dividend is paid out of profits generated from the period prior to the 12-month period, whether the beneficial owner of dividend owned the required percentage of equity during the profit-generating period would not be considered.[26] Generally speaking, the percentage of ownership is the owner's share in registered capital. Additionally, a loan will be considered as capital if income on the loan has been treated as dividend (e.g., under the thin capitalization rule).[27] Furthermore, if a taxpayer undertakes a transaction or arrangement whose primary purpose is to obtain treaty benefit, such transaction or arrangement should not constitute the reason for treaty benefits and the tax authorities can deny such benefits.[28]

Whether a payment is a dividend or interest should be determined based on the principle of substance over form. Interest on a debt instrument generally is not treated as a dividend. However, if the lender actually bears the risks of the borrowing company, the interest can be regarded as a dividend. The following factors should be considered in determining whether a lender shares the risk of the company:[29]

(1) the loan very heavily outweighs any other contribution to the enterprise's capital and is substantially unmatched by redeemable assets;
(2) the creditor will share in any profits of the company;
(3) repayment of the loan is subordinated to claims of other creditors or to the payment of dividends;
(4) the level or payment of interest would depend on the profits of the company;
(5) the loan contract contains no fixed provisions for repayment by a definite date.

"Royalties" as used in the royalty article of a tax treaty has broad meanings, which include the payments of any kind received as a consideration for the use of, or the right to

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[25] Article 3 of the Notice on the Relevant Issues of the Application of Dividend Article of Double Taxation Agreements, Guo Shui Han [2009] No. 81, issued by the SAT on February 20, 2009.

[26] Article 10(2)(ii) of Guo Shui Fa [2010] No. 75.

[27] Article 10(2)(i) of Guo Shui Fa [2010] No. 75.

[28] Article 4 of Guo Shui Han [2009] No. 81.

[29] Article 10(3) of Guo Shui Fa [2010] No. 75.

use, any copyright of literary, artistic, or scientific work including cinematography, films, or tapes for radio or television broadcasting, or any patent, trademark, design or model, plan, secret formula or process, for the use of, or the right to use, industrial, commercial or scientific equipment, or for information concerning industrial, commercial, or scientific experience. Under this broad definition, the royalties not only cover the income from the licensing arrangement but also the equipment rental income. However, as the SAT clarifies, the article does not apply to income derived from the use of immovable properties.[30] The "information concerning industrial, commercial or scientific experience" refers to proprietary technologies. Proprietary technologies generally refer to the information that is not disclosed to public and is necessary for the duplication of a product or a production process.[31] Royalties on licensing proprietary technologies usually involve the permission to use such information by a licensee where the licensor usually does not participate in the implementation of the technology and does not guarantee the result of such implementation. The licensed technology usually exists, but such technology may also include that which is subsequently developed based on the needs of the licensee and the use of which is subject to the confidential and restriction provisions of the licensing contract.[32] In determining whether a fee is considered a service fee or royalty for the purpose of application of a treaty royalty article, the SAT provides the following guidance:

(1) If the service provider applies technology or know-how during the course of provision of services without transferring the technology or know-how, the income from the services is not considered "royalties." However, if certain intellectual property is formed during the services, and the service provider owns the intellectual property, while the service recipient only has a right to use the service outcome, the income for the services will be treated as royalties.[33]
(2) If the technology provider provides support or supervision through its personnel and receives service fees in connection with the transfer or licensing of the technology, such service fees will be treated as royalties regardless of whether the service fees are included in the total price of technology or separately charged. However, if the services performed by those personnel of the technology provider constitute a permanent establishment in China, the business profit article of the tax treaty should apply to the service fees. If a taxpayer cannot accurately allocate the profits attributable to the permanent

[30] Article 1 of the Notice on the Relevant Issues of the Application of Royalty Article of Double Taxation Agreements, Guo Shui Han [2009] No. 507, issued by the SAT on September 14, 2009 and effective on October 1, 2009.

[31] Article 2 of Guo Shui Han [2009] No. 507.

[32] Article 3 of Guo Shui Han [2009] No. 507.

[33] Article 4 of Guo Shui Han [2009] No. 507.

establishment, the tax authorities may make such determination in accordance with the principle of permanent establishment profit allocation under the tax treaty.[34]

(3) The following items or compensation are not royalties and should be service activities:[35]
   (i) The compensation for after-sales services for sales of goods;
   (ii) The compensation for warranty services provided by a seller to a buyer within warranty period of a product;
   (iii) The fees received by professional firms and individuals for professional services such as engineering, management, and consulting services; and
   (iv) Other similar types of compensation prescribed by the SAT.

The business profit article of tax treaty generally should apply to the above services except for a special provision in a tax treaty such as the technical fees provision of the tax treaty between China and the United Kingdom.

Where a licensor sends personnel to China and provides services in connection with its licensing, if the time of services provided in China meets the threshold of a permanent establishment under an applicable tax, the business profit article should apply to the services in connection with the permanent establishment. If the services do not constitute or are not connected with a permanent establishment, the royalty article should apply.[36] If a licensee in China pays licensing fees including service fees before services are provided and it cannot be determined whether the service will constitute a permanent establishment, the royalty article will apply to the fees; if it is subsequently determined that the services are connected with a permanent establishment, the fees will be taxed in accordance to business profit article and tax previously paid on such service under royalty article will be adjusted accordingly.[37] Guo Shui Han [2009] No.507 applies on and after October 1, 2009. If a technology transfer contract was signed before October 1, 2009 and is implemented through a date after October 1, 2009, Guo Shui Han [2009] No. 507 should apply to the service fees where tax has not been paid. In determining a permanent establishment, time incurred for services in China should be accounted. However, no adjustment will be made if CIT on service fee for the prior to October 1, 2009 has been paid in accordance with royalty article.[38]

The royalty article of a tax treaty applies to the beneficial owner of royalties who is a resident of the treaty country. If a resident of Country A has a permanent establishment

[34] Article 5 of Guo Shui Han [2009] No. 507.

[35] Article 6 of Guo Shui Han [2009] No. 507.

[36] Article 1 of the Notice on the Implementation of Relevant Articles of Double Taxation Agreement, Guo Shui Han [2010] No. 46, issued by the SAT on January 26, 2010.

[37] Article 2 of Guo Shui Han [2010] No. 46.

[38] Article 3 of Guo Shui Han [2010] No. 46.

in Country B and the permanent establishment receives royalties from China, the tax treaty between Country A and China should apply. The permanent establishment of a foreign company in China is treated similarly to a China resident for application of royalty article of a tax treaty. Thus, if a permanent establishment of a foreign company in China pays royalties to a resident of a treaty country, the royalty article of the tax treaty between China and the foreign country should apply to the royalties. However, a permanent establishment of a China resident enterprise in a foreign country is not a resident of the foreign country; the royalty article of the tax treaty between China and the foreign country is not applicable to the permanent establishment.[39] Similarly, if a bank is a China resident enterprise, a non-legal person branch established by the bank in a foreign country is China resident; the interest article of a tax treaty between China and the country where the bank is established does not apply to the interest income derived by the branch from China regardless of whether such interest is paid by a China resident or a permanent establishment of a foreign resident.[40]

10.7 Capital Gains

The capital gains article in tax treaties provides the right of contracting countries to impose tax on gains on disposal of assets. The article may prohibit a contracting country from imposing tax on certain transactions. However, the article does not provide a tax rate; once a country is allowed to tax a transaction under a tax treaty, whether the country will actually impose such tax and the amount of tax imposed depends on the domestic law of the country. This section summarizes the right of China to impose CIT on the disposal of assets by resident enterprises of treaty countries and regions under China tax treaties.

China may impose 10 percent CIT on the gains on disposal of properties derived by a non-resident enterprise from China. Tax treaties limit China's ability to exercise this right in certain transactions. The tax treaties between China and most countries and regions classified capital gains into six categories.

The first category is immovable property. If a non-resident enterprise owns an immovable property situated in China, China will have the right to impose CIT on the gains derived by the non-resident from the alienation of immovable property. The term "immovable property" is defined by the laws of a contracting State in which the property in question is situated. The immovable property article of many tax treaties provides that the term shall in any case include property accessory to immovable property, livestock,

[39] Article 7 of Guo Shui Han [2009] No. 507.

[40] Article 2 of the Notice of Issues on the Withholding of Enterprise Income Tax on Interest Income Derived from China by Bank Branches Outside China, Guo Shui Han [2010] No. 266, issued by the SAT on June 2, 2010.

and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, including usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources. Land in China generally is owned by the State; an enterprise may own a land use right for a defined period. A land use right owned by an enterprise, other than real estate investment projects, is typically classified as intangible assets according to China Accounting Standards for Enterprises. For treaty application purpose, the land use right is treated as immovable property in practice.

The second category is movable property as part of a permanent establishment. If the movable property is part of the business property of a permanent establishment of a non-resident enterprise in China, China may impose CIT on gains from the alienation of such movable property derived by the non-resident enterprise. China may also tax such gains where the non-resident enterprise disposes of the permanent establishment (alone or together with the whole enterprise). Accordingly, if a foreign company from a treaty country has a permanent establishment in China and the foreign company disposes of its whole business, China can tax the foreign company on gains from the alienation of the permanent establishment. However, it is not clear if, instead of disposal of business of the foreign company, the owner of the foreign enterprise sells shares of the foreign enterprise, whether the permanent establishment in China should be considered to be disposed of "together with the whole enterprise." There are no written interpretations from Chinese tax authorities on the matter. OECD commentary suggests that this paragraph may not be applicable to capital gains from the elimination of a participation in an enterprise.[41] It is not clear whether a sale of interest in a Chinese partnership is within this category. As a foreign enterprise is only allowed to invest in a Chinese partnership from March 1, 2010, further guidance from the SAT is needed.

The third category is the means of international transportation. Where a non-resident enterprise of a treaty country transfers ships, aircraft, or land vehicles operated in international traffic or movable property pertaining to the operation of such ships, aircraft, or land vehicles, China cannot tax gains on such transfers; only the treaty country can tax such gains. There is no official written interpretation of this provision from the Chinese tax authorities. According to OECD commentaries, this provision applies where the enterprise that alienates the property operates the boats, ships or aircraft itself, whether for its own transportation activities or when leasing the boats, ships, or aircraft on charter, fully equipped, manned and supplied.[42] According to this interpretation, where a resident enterprise of a treaty country operates ships and aircraft in international

[41] OECD Committee on Fiscal Affairs, Model Tax Convention on Income and on Capital, condensed version July 2008, p. 203.

[42] *Id.*

transportation (i.e., between China and the foreign country), only the foreign treaty country has the right to tax the gains on such disposition, even if the ships or aircraft are located in China at the time of disposition. However, this provision will not protect an owner of ships or aircraft who leases the ships or aircraft to an operator. For example, if an owner of an aircraft leases the aircraft to a Chinese airline and the owner sells the aircraft while the aircraft is operated by the Chinese lessee, this provision does not apply. In such situations, the determination has to be made whether the owner has a permanent establishment in China and whether the aircraft is part of the assets of the permanent establishment, if any. If the aircraft is not related to a permanent establishment of the owner, then the owner may be protected by other property provision as discussed in sixth category below.

The fourth category is shares in a land-rich company. If the property of a company consists directly or indirectly principally of immovable property situated in China and if a non-resident enterprise transfers shares of the capital stock of the company, China usually has the right to tax the gains from such transfer. In interpreting the capital gains article of the China-Mexico double taxation agreement, the SAT reviews that the term "consists... principally of immovable property" means more than 50 percent of assets of the company are in real estate.[43] The protocol of the China-Hong Kong tax arrangement provides that "principally" means no less than 50 percent of asset value.[44] According to the SAT, the China-Hong Kong protocol should be tentatively understood as applicable to the situation where greater than 50 percent of the book value of the company assets has consisted in immovable property at some time during the period where the stockholder has held stock in the company.[45] The SAT also provided that the interpretation of China-Hong Kong tax arrangement can apply to the identical articles of other double taxation agreements provided that those articles have not been interpreted differently previously.[46] Subsequent to the SAT's interpretation of China-Hong Kong tax arrangement, China and Hong Kong signed a second protocol. The second protocol reinterprets the article as follows: at least 50 percent of company assets are immovable property at any

[43] Article 5 of the Notice on the Interpretation of Certain Articles of Double Taxation Agreement between the Governments of China and Mexico and Its Protocol, Guo Shui Han [2007] No. 131, issued by the SAT on January 28, 2007.

[44] Article 2 of Protocol of the Arrangement between the Mainland of China and the Hong Kong Administration Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to taxes on Income.

[45] Article 7 of the Notice on the Interpretation and Implementation of Certain Articles of the Arrangement between the Mainland of China and the Hong Kong Administration Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to taxes on Income, Guo Shui Han [2007] No. 403, issued by the SAT on April 4, 2007.

[46] Article 14 of Guo Shui Han [2007] No. 403.

time within the three years before the stockholder transfers the company's stock.[47] In the letters of exchange between the competent authorities of the Mainland of China and Hong Kong concerning the second protocol, the representatives of both parties agree that the percentage of assets usually should be measured based on the book value of the company at each tax year end.[48] The SAT further confirmed this position in a subsequent circular concerning the implementation of the second protocol.[49] Although the determination of a land-rich company based on year-end book does not directly apply to other tax treaties, such measurement can be used as a reference in the application of similar treaty provisions. In some tax treaties, the category of shares in a land-rich company is not separately provided and only the resident country can tax gains not specified in the treaties. By default, China may not tax such gains on disposition of a land-rich company by a resident of a treaty country. However, some of those treaties have been renegotiated and amended. For example, China-Barbados tax treaty contained such a provision that such gains are only taxed in the resident country.[50] However, China and Barbados signed a protocol to the China-Barbados tax treaty on February 10, 2010. The protocol amended the fourth paragraph of the capital gains article of the tax treaty. According to the protocol, gains derived by a resident of Barbados from the alienation of shares deriving more than 50 percent of their value directly or indirectly from immovable property situated in China may be taxed in China.[51] This protocol became effective on June 9, 2010 and is implemented from January 1, 2011.[52] In considering the percentage of asset value directly or indirectly from immovable property, a look-through rule should apply. The SAT provides an example in interpreting the China-Singapore treaty.

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[47] Article 4 of the Second Protocol of the Arrangement between the Mainland of China and the Hong Kong Administration Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to taxes on Income, signed on January 30, 2008.

[48] Letters between Wang Xiaoping, Director of the International Taxation Department of the SAT and Alice LAU MAK Yee-Ming, Commissioner of the Inland Revenue Department of Hong Kong Special Administrative Region on September 11, 2007, see Guo Shui Fa [2008] No. 70, issued by the SAT on July 10, 2008 and effective on June 11, 2008.

[49] Article 2 of the Notice on the Relevant Issues Concerning the Implementation of the Second Protocol of the Arrangement between the Mainland of China and the Hong Kong Administration Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to taxes on Income, Guo Shui Han [2008] No. 685, issued by the SAT on July 19, 2008.

[50] Article 13 of Agreement between the Government of Barbados and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income.

[51] Article 5 of Protocol to the Agreement between the Government of Barbados and the Government of the PRC for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income.

[52] Notice Concerning the Effectiveness and Implementation of Protocol to the Agreement between the Government of Barbados and the Government of the PRC for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Guo Shui Fa [2010] No. 64, issued by the SAT on June 28, 2010.

A Singapore company A owns 20 percent of Chinese company B, which in turn owns 80 percent of Chinese company C. B's asset value is 100 including 40 in real estate. C's asset value is 100 including 90 in real estate. In determining whether more than 50 percent B's asset in immovable property under the China-Singapore treaty, the total asset of B will include its share of asset of C (100 + 100 x 80% = 180); the real estate value will be 112 (40 + 90 x 80%). As such, the value of real estate is 62 percent (112/180) of the total assets.[53]

The fifth category is a transfer of shares of a company by a 25-percent shareholder. Some China tax treaties contain a threshold of 25-percent of ownership in a resident company. According to this type of treaty provision, if a non-resident enterprise owns 25 percent or more of shares of a China resident company, China will impose CIT on the gains from the alienation of shares of the China resident company. There are two questions that often arise on the determination of the 25 percent ownership. The first question is whether a 25-percent owner of a treaty country is taxable in China on sales of its shares in more than one transaction. For example, Enterprise A is a resident of a country with a tax treaty including this 25-percent shareholding provision. A owns 40 percent of shares of a Chinese resident company. A sells half of its shares in the Chinese company and then sells the remaining shares six months later. On the second sale, A owns only 20 percent of the Chinese company. The SAT interpreted this provision in the China-Hong Kong tax arrangement as once a shareholder owns 25 percent, it is always considered as a 25-percent shareholder.[54] Subsequently, the Mainland of China and Hong Kong signed the second protocol, which amended the provision. According to the amended provision, the Mainland of China has the right to tax on capital gains if a Hong Kong resident directly or indirectly owns 25 percent or more of shares of a Mainland company any time within 12 months prior to the transfer of such shares.[55] The second question is whether any rule of attribution applies in computing the 25-percent ownership. Suppose Company A owns 100 percent of Company B and Company C. Each of Company B and Company C owns 20 percent of Company D. Company A, Company B, and Company C are residents of a treaty country with a 25-percent ownership provision and Company D is a Chinese resident company. If Company B sells its 20 percent shares of Company D, can China tax gains on the share transfer? Although Company B owns less than 25 percent of Company D, the Chinese tax authority most likely will view Company B as indirectly owning more than 25 percent. Several recent China tax treaties

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[53] Article 13(4) of Guo Shui Fa [2010] No. 75.

[54] Article 7 of Guo Shui Han [2007] No. 403.

[55] Article 5 of the Second Protocol of the Arrangement between the Mainland of China and the Hong Kong Administration Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to taxes on Income; also see Article 3 of Guo Shui Han [2008] No. 685.

or amendments to treaties provide "directly and indirectly owns 25 percent."[56] This shows the intention of China to assert its right to tax gains on the transfer of shares of a Chinese company where a treaty country resident directly or indirectly owns 25 percent or more of shares of the Chinese company within any time during a 12-month period prior to the transfer. A conclusion cannot be reached that this rule applies to all similar treaty provision; however, reference can clearly be made in application of other treaties with a 25-percent threshold provision. Consider the case in which a Hong Kong individual owns two Hong Kong companies. The first Hong Kong company owned 15.6 percent of a Chinese listed company in Fuzhou, China; the second Hong Kong company owned an additional 22.49 percent of the Chinese company. The first Hong Kong company sold some shares of the Chinese company on the stock exchange. The tax authority in Fuzhou considered that the first Hong Kong company directly and indirectly owned more than 25 percent of Chinese company and therefore imposed tax on the share sales.[57] Subsequently, in interpreting China-Singapore tax treaty, the SAT provides that a Singapore resident's "direct and indirect ownership" in a Chinese company includes the following situations:[58]

(1) The equity of the Chinese company directly owned by the Singapore resident;
(2) The equity of the Chinese company indirectly owned by the Singapore resident through any company or a chain of companies that the Singapore resident owns equity; and
(3) The equity directly owned by any member of a group that has significant economic relationship with the Singapore resident. Such members of group include (i) a person who has identical interest with individual Singapore resident (e.g., direct family members and agent), (ii) an individual or a company that directly owns 100 percent of the Singapore enterprise resident, and (iii) a company directly or indirectly 100 percent owned by the individual or enterprise in (i) and (ii).

The sixth category is all other properties. Some China tax treaties include a provision that exempts China tax on gains from the alienation of any property, other than that

[56] Article 13(5) of the Arrangement between the Mainland of China and the Hong Kong Administration Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to taxes on Income; Article 13(5) of the Agreement between the Government of Mauritius and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income; Article 13(5) of the Agreement between the Government of the People's Republic of China and the Government of Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income.

[57] China Daily Tax News, June 30, 2010, p 1.

[58] Article 13(5) of Guo Shui Fa [2010] No. 75.

specifically mentioned in other paragraphs of the capital gains article, derived by a resident in a treaty country; such gains can be taxed only in the treaty country where the transferor is a resident. Where a tax treaty does not have such a provision, the Chinese tax authorities view that China has the right to tax gains in practice. Instead of the six paragraphs found in the capital gains article, some China tax treaties have fewer paragraphs. In this situation, the last paragraph usually is the catchall paragraph. A number of tax treaties in this category give China the right to tax gains on the alienation of other property arising in China.

Two questions often arise in implementation of this category. The first question is what is the "other property," which is not mentioned in the other paragraphs of the treaty article. For example, paragraph five of the article provides that China may tax gains on the disposal of shares of a Chinese company where the non-resident transferor from the other treaty country owns 25 percent of capital of the Chinese company. What happens if the transferor owns less than 25 percent of capital of the Chinese company? Literally reading this paragraph, one could reach a conclusion that China has the right to tax on gains on the transfer of shares by a less-than-25 percent non-resident as those shares are not mentioned in the other paragraphs of the treaty article. If this conclusion were correct, the article would not need to distinguish the alienator who owns 25 percent or more of capital from less-than-25 percent alienators. One view is that "other property" means property other than the category property mentioned in the other paragraphs. As paragraph five mentions, shares of companies other than those whose property consists directly or indirectly principally of immovable property, shares, regardless of whether owned by a 25-percentowner or not, are consider mentioned in other paragraphs and therefore should be covered by paragraph six. Reading paragraph six in this way will reach a conclusion that China should not have the right to tax the gains derived by an alienator from the other treaty country who owns less than 25 percent of capital of the Chinese company.

The second question is what constitutes "arising in China." The treaties do not provide detailed guidance in this regard. Chinese tax authorities will look at China domestic law in determining whether gains arise in China. For example, a transfer of shares of a Chinese company from a non-resident to another non-resident might be considered as a transaction outside China under the domestic law of the other treaty country; under Chinese law, however, the income would be sourced to the place of the transferred entity and the gains will be considered arising in China.

The table below summarizes the capital gains articles of China tax treaties based on the above categories of properties. The table below shows whether China has right to tax gains derived by a resident of a treaty country (region) on the alienation of property situated in China or shares of a Chinese company or the gains on the alienation of other property arising in China. In this summary, it is assumed that the alienator is not a resident of China. The terms used in the table have the following meanings:

"Y" = China has right to tax;

"N" = only the resident country (region) of alienator, the head office of the alienator, or the place of management of the alienator has the right to tax and China does not;

"Y25-" = China has right to tax if the alienator owns at least 25 percent of Chinese company.

Country	1 Immovable property	2 Movable property as part of permanent establishment	3 Means of international transportation	4 Shares in a land-rich company	5 Shares of company in China other than "4" left	6 Other properties (gains arising in China)
Albania	Y	Y	N	Y		N
Algeria	Y	Y	N	Y		N
Armenia	Y	Y	N			N
Australia	Y	Y	N	Y		Y
Austria	Y	Y	N	Y	Y	Y
Azerbaijan	Y	Y	N	Y		N
Bahrain	Y	Y	N	Y	Y25	N
Bangladesh	Y	Y	N			N
Barbados	Y	Y	N	Y	Y25	N
Belarus	Y	Y	N			N
Belgium[59]	Y	Y	N	Y	Y25	Y
Brazil	Y	Y	N			Y
Brunei	Y	Y	N			N
Bulgaria	Y	Y	N	Y	Y25	MA[60]
Canada	Y	Y	N	Y		Y
Croatia	Y	Y	N	Y	Y25	N
Cuba	Y	Y	N			N
Cyprus	Y	Y	N	Y	Y25	N

Continued

[59] China and Belgium signed a new income tax treaty on October 7, 2009, which is pending for ratification of both countries. The pending treaty makes an exception to China's right to tax on gains derived by a Belgium resident that is a direct or indirect 25-percent owner (Category 4). This exception is the shares in which there is substantial and regular trading on a recognized stock exchange provided that the total of the shares alienated by the resident during the fiscal year in which the alienation takes place does not exceed 5 percent of the quoted shares. The pending treaty also changes "Y" to "No" for Category 6.

[60] Double taxation on gains from capital, other than those mentioned in categories 1, 2, 3, 4 and 5, both Contracting States shall settle the question by mutual agreement.

Country	1 Immovable property	2 Movable property as part of permanent establishment	3 Means of international transportation	4 Shares in a land-rich company	5 Shares of company in China other than "4" left	6 Other properties (gains arising in China)
Czech Republic[61]	Y	Y	N	Y	Y25	Y
Denmark	Y	Y	N			Y
Egypt	Y	Y	N	Y	Y25	N
Estonia	Y	Y	N	Y		N
Finland	Y	Y	N	Y	Y25	N
France	Y	Y	N	Y	Y25	Y
Georgia	Y	Y	N			N
Germany	Y	Y	N			Y
Greece	Y	Y	N	Y		N
Hong Kong SAR	Y	Y	N	Y	Y25	N
Hungary	Y	Y	N	Y		Y
Iceland	Y	Y	N	Y	Y25	N
India	Y	Y	N	Y		Y
Indonesia	Y	Y	N	Y		N
Iran	Y	Y	N	Y		N
Ireland	Y	Y	N	Y		N
Israel	Y	Y	N	Y		N
Italy	Y	Y	N	Y	Y25	Y
Jamaica	Y	Y	N	Y	Y25	N
Japan	Y	Y	N			Y
Kazakhstan	Y	Y	N	Y		N
Korea, Republic of	Y	Y	N	Y		N
Kuwait	Y	Y	N			N
Kyrgyzstan	Y	Y	N	Y	Y25	N
Laos	Y	Y	N	Y	Y25	N

[61] The former Czechoslovak Socialist Republic is divided into Czech Republic and Slovak Republic. Czech Republic has assumed the treaty between China and former Czechoslovak until a new treaty is signed and comes into effect. The information in the table is based on the treaty between China and former Czechoslovak. On August 28, 2009, China and Czech Republic signed an income tax treaty, which is pending for ratification. According to the pending treaty Category 5 will be replaced by "Y" and Category 6 will be replaced by "N."

Country	1 Immovable property	2 Movable property as part of permanent establishment	3 Means of international transportation	4 Shares in a land-rich company	5 Shares of company in China other than "4" left	6 Other properties (gains arising in China)
Latvia	Y	Y	N	Y		N
Lithuania	Y	Y	N	Y		N
Luxembourg	Y	Y	N	Y	Y25	N
Macau SAR	Y	Y	N	Y	Y25	N
Macedonia	Y	Y	N	Y	Y25	N
Malaysia	Y	Y	N	Y		Y
Malta	Y	Y	N	Y	Y25	N
Mauritius	Y	Y	N	Y	Y25	N
Mexico	Y	Y	N	Y	Y	N
Moldova	Y	Y	N	Y	Y25	N
Mongolia	Y	Y	N	Y	Y25	N
Morocco	Y	Y	N	Y		N
Netherlands	Y	Y	N			Y
New Zealand	Y	Y	N			Y
Nigeria	Y	Y	N			[62]
Norway	Y	Y	N	Y	Y25	Y
Oman	Y	Y	N	Y	Y25	N
Pakistan	Y	Y	N	Y	Y25	Y
Papua New Guinea	Y	Y	N	Y	Y25	N
Philippines	Y	Y	N	Y		N
Poland			N			Y
Portugal	Y	Y	N	Y		N
Qatar	Y	Y	N	Y	Y25	N
Romania	Y	Y	N	Y	Y25	Y
Russia	Y	Y	N	Y	Y25	N
Saudi Arabia	Y	Y	N	Y	Y25	N
Seychelles	Y	Y	N	Y	Y25	N

Continued

[62] Capital gains article of Nigeria treaty does not contain "other property" paragraph. Article 22 of Nigeria treaty provides that items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Agreement shall be taxable only in that State. Accordingly, China should not have the right to tax.

Country	1 Immovable property	2 Movable property as part of permanent establishment	3 Means of international transportation	4 Shares in a land-rich company	5 Shares of company in China other than "4" left	6 Other properties (gains arising in China)
Singapore	Y	Y	N	Y	Y25	N
Slovak Republic[63]	Y	Y	N	Y	Y25	Y
Slovenia	Y	Y	N			N
South Africa	Y	Y	N	Y	Y25	N
Spain	Y	Y	N	Y	Y25	Y
Sri Lanka	Y	Y	N	Y	Y25	N
Sudan	Y	Y	N	Y	Y25	N
Sweden	Y	Y	N	Y	Y25	Y
Switzerland	Y	Y	N	Y		N
Tajikistan	Y	Y	N	Y		N
Thailand	Y	Y	N			Y
Trinidad and Tobago	Y	Y	N			N
Tunisia	Y	Y	N			N
Turkey	Y	Y	N	Y		Y 1Yr[64]
Ukraine	Y	Y	N	Y	Y25	N
United Arab Emirates	Y	Y	N	Y		[65]
United Kingdom			N			Y
United States	Y	Y	N	Y	Y25	Y
Uzbekistan	Y	Y	N	Y	Y25	N
Venezuela	Y	Y	N			N
Vietnam	Y	Y	N	Y	Y25	N
Yugoslavia	Y	Y	N	Y		N

[63] The former Czechoslovak Socialist Republic is divided into Czech Republic and Slovak Republic. Slovak Republic has assumed the treaty between China and former Czechoslovak until a new treaty is signed and comes into effect. The information in the table is based on the treaty between China and former Czechoslovak.

[64] China has right to tax on gains derived from China and holding period for one year or less.

[65] Capital gains article of United Arab Emirates treaty does not contain the "other property" paragraph. Article 22 of the treaty, provides that items of income of a resident of a Contracting State, wherever arising, not

10.8 Elimination of Double Taxation

An enterprise may be liable for tax on the same income or capital in more than one jurisdiction. A resident enterprise of China is subject to CIT on the worldwide income of the enterprise; the enterprise may also be subject to tax in another country or region because of doing business in or with the other country or region. On the other hand, a resident enterprise of a foreign country is liable for CIT on income derived from China; the enterprise may also be liable for tax on the same income in its home country. Tax treaties provide for a method of elimination of double taxation.

Most China tax treaties adopt the principle of credit. Under this principle, where a resident of China derives income from another treaty country, the amount of tax on that income payable in the other treaty country in accordance with the provisions of the tax treaty, may be credited against the Chinese tax imposed on the Chinese resident. The amount of the credit, however, cannot exceed the amount of the Chinese tax on that income computed in accordance with the taxation laws and regulations of China. Similarly, where a resident of a treaty country derives income from China, which, in accordance with the provisions of the tax treaty is taxed in China, the treaty country will allow Chinese tax paid as a credit against the income tax of the treaty country. Where the income is dividends paid to a resident of a country by a resident company of another country, some China tax treaties allow indirect tax credit for underlying tax paid by the dividend-paying company. However, to be eligible for the indirect credit, the tax treaties require a minimum of percentage (e.g., 10 percent) of participation of the dividend-receiving company in the dividend-paying company.

The credit principle under tax treaties agrees with the foreign tax credit rule under China domestic tax law. For foreign tax credit computations and claims, see Chapter 9.2. The claim of tax credit for CIT paid in China by a resident of a treaty country in its home country is implemented through domestic law and regulations of the treaty country. Some countries may have a credit system similar to that of China. Some countries may exempt tax on offshore income (e.g., income from China) under domestic law; in such situations, the credit principle adopted in the tax treaty is generally not applicable in those countries because those countries do not impose tax on the income.

Some China tax treaties provide deemed tax credit or sparing tax credit, which will allow a resident of a contracting State to claim tax credit for the amount of tax that has been exempted by another contracting State. Developing countries often provide tax incentives to attract investments or promote economic development. For example, a country may provide an income tax exemption for a period of time. Under the sparing tax credit provision, the resident country of an enterprise will allow the enterprise claim tax

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dealt with in the foregoing Articles of this Agreement shall be taxable only in that State. Accordingly, China should not have the right to tax.

credit for the tax that would have been paid if the tax incentive had not been available. This means that the enterprise may claim a foreign tax credit even though it has not actually paid foreign tax. The sparing tax credit provision is contained in some tax treaties between China and developed countries for the benefit of China. Some tax treaties between China and developing countries contain mutual benefit sparing credit provision. Please also see Chapter 9.2.6.

10.9 Non-Discrimination

This article deals with the elimination of tax discrimination against nationals and enterprises of one contracting State in another contracting State, in certain circumstances. Applying this article contained in a tax treaty between China and a foreign country, China is prohibited from treating the nationals of the foreign treaty country less favorably than Chinese nationals in the same circumstances. The article also requires that the taxation on a permanent establishment that an enterprise of a contracting State has in the other contracting State shall not be less favorably levied in that other contracting State than the taxation levied on enterprises of that other contracting State carrying on the same activities. A permanent establishment of a foreign company in China is subject to a 25-percent CIT under the CIT Law, the same tax rate applicable to a Chinese resident enterprise. The same tax rate treatment for the permanent establishments of non-resident enterprises and resident enterprises is consistent with the treaty article of non-discrimination. The deemed profit method that has been commonly adopted by the Chinese tax authorities to assess CIT of a permanent establishment of a foreign company may be viewed as a tax treatment differently from that for a resident enterprise because the latter is generally assessed on an actual profit basis and various cost and expenses are allowed. A foreign company can request that CIT on its permanent establishment be assessed on an actual basis. If the tax authorities do not ground such request and the foreign company believes that the deemed profit method is discriminatory, the foreign company can seek remedy through the mutual agreement procedures discussed in Chapter 10.10 below.

The non-discrimination article forbids a contracting State from giving less favorable treatment to an enterprise, the capital of which is owned or controlled, wholly or partly, directly or indirectly, by one or more residents of the other contracting State. Applying this provision to China, the resident enterprises owned or controlled, wholly or partly, by the residents of a foreign treaty country cannot be treated less favorably than the resident enterprises owned by Chinese residents. This provision, however, does not apply to a withholding tax imposed on dividends paid to non-resident enterprises because this paragraph only applies to resident enterprises and the taxpayers of such withholding tax are non-resident enterprises. Accordingly, a different tax treatment for dividends (i.e., CIT exemption on dividends paid by a resident enterprise to another resident enterprise;

10 percent withholding tax on dividends paid by a resident enterprise to a non-resident enterprise) is not considered a violation of this non-discrimination provision.

10.10 Mutual Agreement Procedures

This article provides for mutual agreement procedures for resolving difficulties arising out of the application of a tax treaty between China and a treaty country or region. Where an enterprise considers that the actions of one or both of contracting states result or will result for it in taxation not in accordance with the provisions of the tax treaty, it may, irrespective of the remedies provided by the domestic law of those contracting states, present its case to the competent authority of the country or region of which it is a resident. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the tax treaty. The competent authorities shall endeavor by mutual agreement to resolve the situation of taxpayers subjected to taxation not in accordance with the provisions of the tax treaty. The article authorizes the competent authorities to communicate with each other directly. It would therefore not be necessary to go through diplomatic channels. To facilitate reaching a mutual agreement, the competent authorities may meet for an oral exchange of opinions.

The mutual agreement procedure does not exclude any action pursuing a remedy under domestic law. A taxpayer can simultaneously seek a remedy under domestic law and attempt to resolve the situation through the mutual agreement procedure.

10.11 Exchange of Information

Double taxation agreements contain an article of exchange of information. According to this article, the competent authorities of treaty countries shall exchange such information as is necessary for carrying out the provisions of the tax treaty, in particular for the prevention of evasion of taxes covered by the tax treaty. As such, China can request the information of a taxpayer or related parties from the competent authority of its treaty partner; vice versa, China is obligated to provide the information upon the request of the competent authority of a treaty country or region. The article concerning an exchange of information request includes the provision that a contracting State must keep the information received from another contracting State confidential. The contracting State can disclose the information only to persons or authorities (including courts and administrative bodies) involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the tax treaty. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

In spite of the provision of exchange of information, a contracting State is not obligated to (1) carry out administrative measures at variance with the laws and the administrative practice of that or of the other contracting State; (2) supply information that is not obtainable under the laws or in the normal course of the administration of that or of the other contracting State; and (3) supply information that could disclose any trade, business, industrial, commercial or professional secret or trade process, or information, the disclosure of which would be contrary to public policy.

In addition to the provision of exchange of information in double taxation agreements, China has signed Tax Information Exchange Agreements with Argentia, Bahamas, Bermuda, the British Virgin Islands, Guernsey, Isle of Man, and States of Jersey, respectively. Under a Tax Information Exchange Agreement, the competent authorities of the contracting States shall provide assistance through exchange of information that is foreseeably relevant to the administration and enforcement of the domestic laws of the contracting states concerning taxes covered by the agreement. Such information includes information that is foreseeably relevant to the determination, assessment, verification and collection of such taxes, the recovery and enforcement of tax claims, and the investigation or prosecution of tax matters. Accordingly, the Tax Information Exchange Agreement allows China to obtain various kinds of information that are relevant to a tax investigation conducted by the Chinese tax authorities, including the information relating to bank accounts or the beneficial ownership of companies or trusts.

To implement the treaty provision concerning tax information exchange, the SAT issued the Rules and Procedures for International Tax Information Exchange.[66] The exchange of information is generally limited to (1) the exchange with the countries that have an effective tax agreement with an information exchange provision; (2) for the categories of tax covered by the tax treaty that are primarily those in the nature of income and property; (3) concerning the residents of one or both contracting states; and (4) within the territory that the contracting states have effective tax jurisdiction.[67] The tax circular classifies tax information exchange into six categories.[68]

The first category is information exchange on request. This refers to the situation where the competent authority of a contracting State asks for specific questions in connection with a specific case and requests that the competent authority of another contracting State provide relevant information and assist in investigation, including obtaining, investigating, or confirming the information, documentation, and records, concerning the identity of companies or individuals, the receipt or payment of purchase price, expenses, property transfer, or the use of property that is related to tax payment.

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[66] The Rules and Procedures for International Tax Information Exchange, Guo Shui Fa [2006] No. 70, issued by the SAT on June 12, 2006 and effective on June 12, 2006.

[67] Article 8 of Guo Shui Fa [2006] No. 70.

[68] Article 7 of Guo Shui Fa [2006] No. 70.

The second category is automatic information exchange. This refers to the systematic and periodic transmission of bulk taxpayer information by the source country to the residence country concerning various categories of income. Those categories of income primarily include interest, dividends, royalties, salary and wages, various allowances, bonus, pension, commission, service fees, the income on the transfer of properties, and business income.

The third category is spontaneous information exchange. This refers to the provision of information by the competent authority of a contracting State to the competent authority of another contracting State that is foreseeably relevant to the other contracting State and that has not been previously requested. When the competent authority of a contracting State obtains certain information during the enforcement of domestic law and believes that such information can assist the competent authority of the other contracting State in implementing the tax treaty, the competent authority of the first contracting State may provide such information on its own initiative to the competent authority of the other contracting State. This type of information includes the facts and documents relevant to tax payments of companies and individuals concerning the receipt or payment of transaction price and expenses, property transfer, or the provision of property for use.

The fourth category is simultaneous tax examination. This refers to the situation where the competent authorities of contracting States examine, simultaneously and independently, each on its own territory, the tax affairs of a taxpayer or a group of taxpayers in which they have a common or related interest, and for which they exchange any relevant information obtained according to a simultaneous tax examination agreement.

The fifth category is the visit of an authorized representative. This refers to a tax examination abroad. According to an agreement between two contracting states, the competent authority of a contracting State, upon the consent of the competent authority of another contracting State, may send its tax examination officials to visit the other State and obtain, examine and confirm tax information within the tax jurisdiction of the other State.

The sixth category is industry-wide exchange of information. This refers to the investigation, study, analysis, and exchange of information of a particular industry by the competent authorities of contracting States. This type of information exchange concerns a whole economic sector and not taxpayers in particular, which can be the operating models, financing patterns, pricing models, and the methods of tax evasion of a particular industry.

The SAT may decline to provide the information requested by the competent authority of a contracting State in one of the following situations:[69]

(1) The information is not relevant to tax collection;
(2) The information requested is not pertinent;

[69] Article 9 of Guo Shui Fa [2006] No. 70.

(3) The information request is not signed by the competent authority or authorized representative of a contracting State;
(4) The information is outside the scope of persons, categories of tax, and territory as provided in the tax treaty;
(5) Where a contracting State requests for information for the implementation of domestic law of the State, the provision of the country's domestic law conflicts with the provision of tax treaty;
(6) The provision of information would damage the national interest of China;
(7) The provision of information may result in disclosure of commercial secrecy;
(8) The provision of information may result in a discrimination against the nationals or residents of China;
(9) The information cannot be obtained through normal administrative procedures in accordance with laws and regulations of China;
(10) The information can be obtained by the contracting State through normal administrative procedures and with efforts within the contracting State; and
(11) Other situations that the SAT believes do not comply with the provision of exchange of information of tax treaty.

Where a tax bureau at provincial level or below needs the assistance of the competent authority of a contracting State in obtaining information for the implementation of the tax treaty or the domestic law involving the categories of tax relevant to the tax treaty, the tax bureau may request for an exchange of information. Such a request should be submitted to the SAT level-by-level. The request may include the following:[70]

(1) Obtaining or confirming the existence of books and records that are retained by the other party of a transaction or a foreign branch and the other party or foreign branch is located in the contracting State;
(2) Obtaining or confirming the existence of the bank account number, amount of transaction, and payment records for a transaction between a taxpayer and a foreign company where the financial institution is located in the contracting State;
(3) Obtaining or confirming the existence of the tax filing made by a party to a transaction where such party is located in the contracting State;
(4) Obtaining the basic information about a taxpayer or another party to a transaction with the taxpayer, or information related to an income received by the taxpayer where the information is located in the contracting State. Such information includes the actual address and resident status of an individual or a company, the registered address of a company, the shareholding information of a company;

[70] Article 11 of Guo Shui Fa [2006] No. 70.

(5) The confirmation of the authenticity and legality of information relevant to tax that has been provided by a taxpayer;
(6) The confirmation of the relation between a taxpayer and its related enterprises in the contracting State and obtaining the basic information of such related enterprises, including the contracts, the articles of the association, financial statements, tax returns, the audit report of the certified public accountant of the related enterprises that are not listed on a stock exchange, and the information on transactions between the taxpayer and the related enterprises;
(7) Obtaining the nature and amount of dividends, interest, royalties, proceeds from property transfer, allowances, bonuses, commissions, or other income items that were received by a taxpayer from the contracting State or paid by the taxpayer to the contracting State;
(8) Confirming the authenticity of the price and amount of a transaction between a taxpayer and a company in the contracting State;
(9) Confirming the authenticity of income or expenses reported by a taxpayer;
(10) Confirming the authenticity and legality of tax paid in the contracting State; and
(11) Obtaining other information that is necessary for tax audit or tax administration collection and that may be retained in the contracting State.

The information obtained in tax information exchange from a contracting State can be used as a basis for tax collection in China. Such information can also be presented to the court in tax litigation. However, if the competent authority of a contracting State expressly requests that a prior consent be required for the use of information in litigation, such matter should be handled by the SAT with the competent authority of the contracting State through mutual agreement procedures.[71] Furthermore, if a tax case is involved in criminal prosecution and the court needs to use the information obtained from a contracting State as evidence for a criminal offense where the competent authority of a contracting State expressly requires a prior consent for this use of information, then the tax authority should inform the court and report to the SAT and the SAT will consult with the competent authority of the contracting State to determine the scope and degree of use of the information.[72]

Tax information is treated as confidential information. The information can be classified into three levels based on the degree of secrecy, "confidential," "very confidential," and "strictly confidential." Tax information generally should be classified as "confidential." Where the information is related to a tax evasion, a tax fraud, or other acts seriously violating tax law, or where the competent authority of a contracting State has special

[71] Article 13 of Guo Shui Fa [2006] No. 70.

[72] Article 15 of Guo Shui Fa [2006] No. 70.

requirements for confidentiality, such information should be classified as "very confidential." Where the tax information includes important State secrets, the disclosure of which would harm national security or very important State interests, such information should be classified as "strictly confidential."[73] Generally speaking, the confidential periods for "confidential," "very confidential," and "strictly confidential" information are ten years, twenty years, and thirty years, respectively.[74] The tax authorities may notify a relevant taxpayer, a withholding agent, or other relevant parties of the purpose of information exchange, the source of information, and the content of information; they may also provide the above information to the government office or personnel who are in charge of administration of tax covered by the tax treaty. The tax authorities should inform the agency or personnel receiving information of the obligation to keep information confidential. However, a tax authority cannot, without the approval of the SAT, provide the information to the taxpayer, withholding agent or other relevant party if the taxpayer, withholding agent, or other relevant party is suspected of committing a tax crime and the provision of information would affect the case investigation, or if the contracting State requires that the source and content of information should not be disclosed to the taxpayer, withholding agent, or the other relevant party.[75] When the information is used as evidence in litigation, the tax authority may request of the court that the evidence not be produced in a public hearing in accordance with the Law of Administrative Procedures.[76] Unless otherwise provided in an applicable tax treaty, the tax authorities cannot forward or disclose the information obtained from exchange to other agencies or personnel who are not related to tax administration. If the State audit department, discipline inspection agencies, and the departments against financial crimes require relevant tax information, the tax authorities may provide the information to those agencies only upon the approval of the SAT.[77] The tax authorities cannot disclose the source and content of tax information in a written tax document such as a notice, public notice, a decision on tax treatment, and a decision on tax penalty.[78]

10.12 How to Obtain Treaty Benefits

For a long period of time, China had flexible procedures for claims for treaty benefits. The SAT issued a form for the claims for tax exemption or reduction of tax rate under tax treaties; some circulars provided the requirements for resident certificates issued by

[73] Article 17 of Guo Shui Fa [2006] No. 70.
[74] Article 18 of Guo Shui Fa [2006] No. 70.
[75] Article 27 of Guo Shui Fa [2006] No. 70.
[76] Article 28 of Guo Shui Fa [2006] No. 70.
[77] Article 29 of Guo Shui Fa [2006] No. 70.
[78] Article 30 of Guo Shui Fa [2006] No. 70.

competent authorities of treaty countries. However, there was a lack of specific procedures for the claims for treaty benefits. The practice varied in different locations. Tax authorities in many locations sometimes allowed the application of a treaty provision without formal resident certification, and instead based their decisions on information from documents such as business license and contracts. In August 2009, the SAT issued Administrative Measures for Claims for Tax Treaty Benefits by Non-residents (Trial Implementation),[79] which provided guidelines for application, filing, and review procedures for claims for tax exemption or reduced tax rates under double taxation treaties. The measures apply to the tax liabilities occurred on or after October 1, 2009. It also applies to a tax liability that occurred prior to October 1, 2009 and for which the claim for treaty benefits is made on or after October 1, 2009. The Measures govern the implementation of all tax treaty benefit claims except for those provided under international transportation provisions of tax treaties.

10.12.1 Claims for Treaty Benefits for Dividend, Interest, Royalty, and Gains on Transfer of Properties

To enjoy a tax exemption or reduced tax rate under treaty provisions concerning dividends, interest, royalty, and gains on transfer of properties, a non-resident must apply to and obtain specific approval of the relevant tax authorities for such benefits. A taxpayer must submit the following documents to the tax authority:[80]

(1) An application form, Non-resident's Claim for Treatment under Double Taxation Agreement (for Approval). The form includes the taxpayer's basic information and the information concerning the transaction for which the taxpayer claims treaty benefit, including the type of income, tax withholding agent information, applicable treaty provision, reasons for enjoying treatment under the treaty, and a disclosure as to whether the transaction is a related party transaction.

(2) Personal Information of Non-residents Claiming Treatment under Double Taxation Agreement, a form that requires various information concerning qualification of resident status. The taxpayer must provide specific legal basis for its claim for treaty benefits. For an enterprise taxpayer, it is also required to disclose the nature of business, description of major projects and business in the treaty country for the last year, the total amount of gross income arising in the treaty country in the past year, the number of employees in the treaty country,

[79] Administrative Measures for Claims for Tax Treaty Benefits by Non-residents (Trial Implementation), Guo Shui Fa [2009] No. 124, issued by the SAT on August 24, 2009 and effective on October 1, 2009.

[80] Article 9 of Guo Shui Fa [2009] No. 124.

and all direct or indirect 10-percent shareholders of the taxpayer. The taxpayer also needs to disclose transactions with and payments to related parties in jurisdictions other than China and the taxpayer's resident country (claimed treaty country) with respect to payment for transactions on loans, franchise and licensing, provision of technical or managerial services, and property alienation.

(3) A resident certificate issued by the competent authority of treaty country or region. The resident certificate must be dated on or after January 1 of the year immediately prior to the year of application.

(4) Documents that evidence the taxpayer's right to the payment such as property ownership certificate, contract, agreement, payment voucher, or certificate issued by an intermediary or notary agent.

(5) Other documents which may be required by the tax authorities in relation to claim for treatment under double taxation agreement.

If a taxpayer previously provided some of the above documents to tax authorities, the taxpayer does not need to resubmit the same documents. However, the taxpayer must state the office name of the tax authorities that previously accepted the document and the time of acceptance.[81] This exemption for filings with a tax authority is only available if the documents were previously provided to the same tax bureau in charge. For the application for treaty benefit with different tax bureaus in charge, the documents should be submitted to the tax bureaus separately.[82] The application can be made before a payer makes a payment to the non-resident. If a non-resident who is eligible for treaty benefits paid tax at the normal rate according to domestic law, the non-resident may apply for treaty benefits and claim a tax refund within three years from the date of tax payment.[83]

A non-resident should submit the application to the tax authority in charge, which generally is the district, county, or city tax bureau in charge of the payer. However, not all of those tax bureaus have the right to approve an application for treaty benefits. Tax bureaus at provinces, municipalities, autonomous regions, and the cities specifically designated in the State plan can designate certain tax bureaus as approval authorities within their jurisdictions based on the availability of resources and work loans within their jurisdictions.[84] . If a tax bureau in charge is not an authorized bureau, it will forward the application to the authorized tax bureau. An authorized tax bureau may delegate a lower level tax bureau to investigate and confirm relevant information. If the application

[81] Article 9 of Guo Shui Fa [2009] No. 124.

[82] Article 3 of Supplemental Notice on Relevant Issues Concerning Administrative Measures for Claims for Tax Treaty Benefits by Non-residents (Trial Implementation), Guo Shui Han [2010] No. 290, issued by the SAT on June 21, 2010.

[83] Article 21 of Guo Shui Fa [2009] No. 124.

[84] Article 8 of Guo Shui Fa [2009] No. 124.

materials submitted by a taxpayer are not accurate or is incomplete, the tax authority should notify the taxpayer; the taxpayer should be allowed to make correction or provide additional information.[85] However, the tax authority can decide not to accept the application if the taxpayer cannot provide necessary information within ninety days of the tax authority's notice without proper reasons.[86] An authorized tax bureau should approve or reject the application within a prescribed review period. The review period is twenty working days if the approval authority is a tax bureau at district and county level, thirty working days if the approval authority is a tax bureau at prefecture and city level, and forty working days if the approval authority is a tax bureau at provincial level. If the tax authority cannot make a decision within the above review period, it can extend the review period an additional ten working days upon the approval of the tax bureau head and upon the delivery of a written notice to the taxpayer. If the tax bureau has not issued a written notice to the taxpayer within the allowed review period, including extension of time, the bureau is deemed to have approved the treaty benefit claim.[87] If an authorized tax bureau is not able to determine whether the non-resident can enjoy a treaty benefit, it may notify the taxpayer in writing of temporarily not granting treaty benefits and reasons therefor. In such situations, the tax bureau must report it to the higher-level tax bureau and, if necessary, commence mutual agreement or information exchange procedures with the relevant treaty country or region.[88]

An approval for treaty benefit item is valid for three calendar years (i.e., the remaining period of current year plus following two following calendar years) for the same non-resident and same type of benefit under the same tax treaty.[89] For example, if a foreign company receives an approval for a reduced withholding tax rate on a dividend payment made by a resident enterprise under a tax treaty, the foreign company can enjoy the reduced rate for subsequent dividend payments from the same resident enterprise within the valid period without additional application. However, the foreign company must separately apply for the enjoyment of reduced tax rate if it receives dividends from another resident enterprise. Similarly, if a foreign company obtains approval for reduced tax rate on interest on a loan paid by a resident enterprise, the benefit approved only applies to the interest on the same loan within the valid period. The foreign company must separately apply for treaty benefits for interest income if it subsequently makes additional loans to the same resident enterprise. For royalties, the approved benefit only applies to the royalty payments under the same licensing agreement. In addition to the initial application and approval, during the implementation of a treaty benefit approval,

[85] Article 14 of Guo Shui Fa [2009] No. 124.

[86] Article 15 of Guo Shui Fa [2009] No. 124.

[87] Article 16 of Guo Shui Fa [2009] No. 124.

[88] Article 17 of Guo Shui Fa [2009] No. 124.

[89] Article 10 of Guo Shui Fa [2009] No. 124.

the taxpayer or withholding agent must file a form, Report of Implementation of Non-resident's Treatment Upon Approval under Double Taxation Agreement, to report the actual implementation status.[90]

10.12.2 CLAIMS FOR BENEFITS UNDER OTHER TREATY PROVISIONS

To enjoy treaty benefits other than those for dividend, interest, royalty, and gains on transfer of properties, a non-resident does not need to obtain a specific approval. However, prior to a tax liability at the time of tax filing, the non-resident or a withholding agent must file an information reporting form, Non-resident's Claim for Treatment under Double Taxation Agreement, together with a resident certificate issued by the competent authority of treaty country or region and other documents that may be required by the tax authorities.[91] The resident certificate must be dated on or after January 1 of the year immediately prior to the year of filing.

According to China tax treaties, the business profits of a foreign enterprise from a treaty country generally will not be taxable in China unless the foreign enterprise has a permanent establishment in China and the business profits are derived from the permanent establishment. A "permanent establishment" is a fixed place of business through which the business of an enterprise of a treaty country is wholly or partly carried on. For the provision of services by a foreign enterprise in China, the foreign enterprise will be considered having permanent establishment in China if the service activates by the foreign enterprise through employees or other personnel engaged by the foreign enterprise continue within China for a certain period of time. Most treaties provide for a period or periods aggregating more than six months within any twelve-month period.

Many foreign companies from treaty countries provide services in China, which may include undertaking engineering or installation projects, performing technical service contracts, and providing various consulting services. According to Guo Shui Fa [2009] No. 124, the claims for benefits under treaty provisions concerning business profits and permanent establishment do not require an approval and are only required for filing of the above information with the tax authority in charge. However, a tax certificate is required for remittance of foreign exchange of more than USD30,000. If a foreign company claims for tax exemption because its activities do not constitute a permanent establishment in China, the tax authority in charge most likely will conduct a substantial review of filing documents for treaty benefit claim before issuing a tax clearance certificate. As it is not clear how to count for the six-month (or more number of months in some treaties) period under the current tax law and regulations, it may not be easy for the tax authorities to agree to the non-permanent establishment position of the foreign

[90] Article 18 of Guo Shui Fa [2009] No. 124.

[91] Articles 11 and 12 of Guo Shui Fa [2009] No. 124.

company in some situations. Accordingly, it may be difficult to implement "merely filing for records" as provided in the tax circular in those situations.

10.12.3 RECORD RETENTION, EXAMINATION, AND PENALTIES

If a taxpayer has enjoyed tax treaty benefits, the taxpayer and withholding agent must maintain documents and records in relation to the treaty benefit claims for at least ten years.[92] Taxpayers and withholding agents are required to report if the information filed changes subsequently. If such change does not affect a taxpayer's continuing to enjoy the treatment under the applicable treaty, the taxpayer can continue to do so. If the change of information affects its claim for treatment under the applicable tax treaty, the taxpayer should re-apply or re-file according to Guo Shui Fa [2009] No. 124. If the change of information results in ineligibility for treaty benefit, the taxpayer should stop claiming for the treaty benefit and pay tax in accordance with domestic law and regulations.[93]

The tax authorities may randomly select taxpayers (for both approved cases and information filing cases) for review and reconfirmation of eligibility of treaty benefits. The scope of review includes (1) whether the non-resident obtained the tax benefit by not disclosing relevant information or providing false information; (2) whether a non-resident correctly performed its obligations when treaty application conditions change; (3) whether a non-resident has enjoyed treaty benefits without proper application or filing; (4) whether the approval authority has appropriately carried out its duty of approval and the whether the approval is correct; and (5) whether there are other non-compliance issues.[94]

If the tax authority in charge finds that a non-resident has enjoyed treaty benefits without performing the appropriate obligations, it should make a decision to not allow the resident to enjoy the treaty benefits if one or more of the following situations exist:[95]

(1) The non-resident has not applied for the benefits in accordance with Guo Shui Fa No. 124 or, although the non-resident applied, the tax authority has not approved or has been deemed to approve the application, and the taxpayer has not complied the notice of tax authority to correct its position within the period specified by the tax authority without justifiable reasons;
(2) The non-resident has not filed a report for claiming the benefits in accordance with Guo Shui Fa No. 124, and the taxpayer has not complied the notice of tax

[92] Article 22 of Guo Shui Fa [2009] No. 124.
[93] Article 20 of Guo Shui Fa [2009] No. 124.
[94] Article 24 of Guo Shui Fa [2009] No. 124.
[95] Article 27 of Guo Shui Fa [2009] No. 124.

authority to make a correction within the period specified by the tax authority without justifiable reasons;

(3) The non-resident has not provided relevant documents in accordance with Guo Shui Fa No. 124, and the taxpayer has not complied the notice of tax authority to make a correction within the period specified by the tax authority without justifiable reasons;

(4) The taxpayer has not provided supplemental information as required by the tax authority within the period specified by the tax authority without justifiable reasons;

(5) Due to the change of circumstances, the non-resident should have stopped enjoying treaty benefits;

(6) Upon the investigation and confirmation by the tax authority, other situations that the resident should not have enjoyed treaty benefits.

In the above situations, the non-resident will be required to pay additional tax in accordance domestic law without treaty benefits. Late payment charge and penalties may also be imposed. For a failure to file necessary application and/or documents, the tax authority can impose a fine of not more than RMB 2,000; in a serious case, a fine of RMB 2,000 to RMB 10,000.[96] If false information is provided in application or information filing, the tax authority may impose a fine equal to 50 percent to 500 percent of tax underpaid.[97] The tax authority may also impose on the withholding agent a fine equal to 50 percent to 300 percent of tax under-withheld.[98] In situations (1) through (4) above, the non-resident may, within three years of the settlement of additional tax, file necessary application and document and make necessary correction action as required by the tax authority. After the tax authority confirms that the non-resident is eligible for treaty benefits, the non-resident will regain the eligibility for treaty benefits. In such situation, the non-resident can obtain a refund of tax paid in excess of amount in accordance with the applicable tax treaty; however, the late payment charge, penalty, and interest are not refundable.[99]

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[96] Article 32 of Guo Shui Fa [2009] No. 124; Article 62 of the Law of Administration of Tax Collection.

[97] Article 34 of Guo Shui Fa [2009] No. 124; Article 63 of the Law of Administration of Tax Collection.

[98] Article 34 of Guo Shui Fa [2009] No. 124; Article 69 of the Law of Administration of Tax Collection.

[99] Article 28 of Guo Shui Fa [2009] No. 124.

11

TRANSFER PRICING

11.1 General Principle

"Transfer pricing" is a term of art referring to the prices charged for transactions between related parties. Prices charged for transactions between unrelated parties after bargaining are commonly referred as to arm's-length prices. Transfer pricing rules require that the transactions between related parties be conducted on the arm's-length basis. The main objective of the transfer pricing rule is to prevent taxpayers from shifting profits from a high-tax jurisdiction to a low-tax jurisdiction. The CIT Law authorizes the tax authorities to make adjustments using reasonable methods if a business transaction between an enterprise and a related party does not comply with the arm's-length principle, thus reducing the taxable income or revenue of the enterprise or the related party.[1] "The arm's-length principle" refers to the principle of adopting fair market prices and business norms for transactions carried out between non-related parties.[2] The Law of Administration of Tax Collection also authorizes the tax authorities to make the tax adjustment for related party transactions not in compliance with the arm's-length

[1] Article 41 of the CIT Law.

[2] Article 110 of the CIT Implementation Rules.

principle.[3] On January 8, 2009, the SAT issued the Implementation Rules for Special Tax Adjustments (Trial Implementation).[4] The rules have provided more detailed guidance on the special tax adjustments, including, among others, transfer pricing, advanced pricing arrangements, and cost sharing agreements. The rules replace several tax circulars on transfer pricing previously issued and are retroactively effective from January 1, 2008.

Unlike transfer pricing rules in some other countries, China transfer pricing rules apply not only to cross-border transactions but also to transactions within China. Due to various tax incentives available under the CIT Law and the CIT Implementation Rules, the effective tax burdens of enterprises within China may be different. The application of transfer pricing rules to the transactions between related parties within China is to prevent enterprises from artificially moving profits from high-tax burden enterprises to low-tax burden enterprises.

11.2 Related Parties

The CIT Implementation Rules and the Implementation Rules for the Law of Administration of Tax Collection of the PRC[5] broadly define related parties.[6] The SAT further defines the related parties in the Implementation Rules for Special Tax Adjustments.[7] According to these regulations, an enterprise is a related party to another enterprise, organization, or individual if one of the following conditions is met:

(1) One party directly or indirectly owns at least 25 percent of the equity of another party, or a third party directly or indirectly owns at least 25 percent of both parties. In computing the indirect ownership, if a party owns 25 percent or more of an intermediate holding enterprise that in turn holds equity of another party, the full percentage of ownership of the intermediate holding enterprise in the other party is considered as the percentage of ownership of the party in the other party. For example, assume Company A owns 25 percent

[3] Article 36 of the Law of PRC on Administration and Collection of Tax, adopted by the Standing Committee of the NPC on September 4, 1992, amended by the Standing Committee on February 28, 1995 and April 28, 2001.

[4] Guo Shui Fa [2009] No. 2.

[5] State Council Order [2002] No.362, issued by the State Council on September 7, 2002 and effective on October 15, 2002.

[6] Article 109 of the CIT Implementation Rules; Article 51 of State Council Order [2002] No.362.

[7] Article 9 of Guo Shui Fa [2009] No. 2.

of Company B and Company B owns 25 percent of Company C, Company A will considered as owning 25 percent of Company C even though the actual indirect ownership of Company A in Company C is only 6.25 percent. Under this attribution rule, Company A and Company C are related parties.

(2) One party takes a loan from another party (other than an independent financial institution) in an amount equal to or more than 50 percent of the borrower's actual paid-in capital, or 10 percent or more of the total debt is guaranteed by another party (other than an independent financial institution).
(3) At least half of the senior management personnel (including directors and managers) or at least one senior member of the board of directors who may control the board of one party is appointed by another party, or at least half of the senior management personnel (including directors and managers) or at least one senior member of the board of directors who may control the board of both parties is appointed by the same third party. "Managers" are not defined. They should be senior management personnel rather than mid-level managers of enterprises. In practice, people commonly treat the president/general manager, vice president/deputy general manager, chief accountant, and other senior management personnel in the same level of as senior management of the enterprise.
(4) At least half of the senior management personnel (including directors and managers) of one party are also senior management of another party, or at least one senior member of the board of directors who may control the board of one party is also a senior member of the board of directors of another party.
(5) The normal operation of production or business of one party is dependent on the industrial property or proprietary technology licensed by another party.
(6) The sales or supplies of one party are primarily controlled by another party.
(7) The provision or receipt of services is principally controlled by another party.
(8) One party has substantial control over the production, operation, and trading activities of another party, or both parties have other types of related beneficial interest, including one party and the main shareholder of another party having common economic interest even though the shareholding presentment requirement of item 1 above is not satisfied, as well as family relations.

Such broadly defined related parties have made many transactions subject to the transfer pricing rules. In practice, the tax authorities may not necessarily look at all the conditions above to identify related parties all the time, but the broad definition does give the tax authorities the power to make transfer pricing investigations on many transactions.

11.3 Types of Transactions Covered

China transfer pricing rules cover a broad range of related party transactions. The Implementation Rules for Special Tax Adjustments lists four categories of related party transactions,[8] including:

(1) The purchase, sale, transfer, and use of tangible assets. This category of transactions includes the purchase, sale, transfer, or lease of buildings and structures, and the means of transportation, machinery and equipment, tools, commodities, and products.
(2) The transfer and use of intangible assets. This category of transactions covers the transfer of ownership of land-use rights, copyrights, patents, trademarks, customer lists, distribution channels, brands, trade secrets, know-how, and industrial property such as industrial designs and utility models. This category also covers the transactions for use of these intangibles, such as licensing activities.
(3) Financing. This category of transactions includes all kinds of long-term and short-term loans, guarantees, and all types of interest bearing advance payments and deferred payments.
(4) The provision of services. This category of transactions includes all kinds of services such as market survey, marketing, management, administration, technical, maintenance, design, consulting, agency, scientific research, legal, and accounting.

11.4 Transfer Pricing Methodologies

The transfer pricing regulations prescribe various methods that can be used by the Chinese tax authorities when assessing whether related party transactions are in compliance with the arm's-length standard. These methods include the Comparable Uncontrolled Price Method (CUP), the Resale Price Method (RPM), the Cost-Plus Method (CPLM), the Transactional Net Margin Method (TNMM), the Profit Split Method (PSM), and other methods consistent with the arm's length principle. The tax regulations do not give priority to any of the methods. The selection of a reasonable method should be based on a comparability analysis of major factors of a transaction such as the characteristics of assets and services, the function and risk of the transaction parties, contract terms, the economic environment, and business strategies. According to the Implementation Rules

[8] Article 10 of Guo Shui Fa [2009] No. 2.

for Special Tax Adjustments, these methods are usually applicable to the following types of related party transactions:

Method	Purchase, sales, or transfer of tangible assets	Use of tangible assets	Transfer or use of intangible assets	Financing	Provision of services
CUP	√	√	√	√	√
RPM	√				
CPLM	√	√		√	√
TNMM	√	√	√		√
PSM	√	√	√		√

The following sections outline the details of various transfer pricing methods as provided by the transfer pricing regulations.

11.4.1 COMPARABLE UNCONTROLLED PRICE METHOD

CUP refers to the pricing method based on a price for identical or similar business transactions conducted between non-related parties.[9] According to the OECD transfer pricing guidelines, the CUP method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances. If there is any difference between the two prices, this may indicate that the conditions of the commercial and financial relations of the related parties are not arm's-length, and that the price in the uncontrolled transaction may need to be substituted for the price in the controlled transaction. The CUP method requires a high degree of comparability of products and functions. Comparability analysis should be made in examining the differences in the characteristics of the transacted properties and services, in the contractual terms and economic environment between the related party transactions and unrelated party transactions.[10] The transfer pricing regulations provide those differences that should be considered for different types of transactions.

For the purchase, sale, or transfer of tangible properties, the differences should be considered in four areas. The first area is the process of the purchase, sale or transfer. This mainly includes the time and venue of the transaction, the terms of delivery, procedures of delivery, terms of payment, quantity of the transaction, and time and venue of

[9] Article 111(1) of the CIT Implementation Rules.

[10] Article 23 of Guo Shui Fa [2009] No. 2.

after-sale services. The second area is the stage of the purchase, sale or transfer. This mainly includes the stages of manufacturing, wholesale, retail, and export. The third area consists of the products, and mainly includes the name, brand, specifications, models, function, structure, appearance, and packaging,. The fourth area is the environment of the transaction, which mainly includes local customs, consumer preferences, the degree of political stability, and the fiscal, tax, and foreign exchange policies.[11]

For the use of tangible assets, the differences should be considered in three areas. The first area includes the functions, specifications, models, configurations, types, and method of depreciation of the assets. The second area encompasses the time, duration, and location of using the assets as authorized in the transaction. The third area involves the investment expenditures and maintenance costs of the asset owner in relation to the assets.[12]

For the transfer or use of intangible assets, the differences should be considered in two areas. The first area consists of the types, usage, applicable industries, and expected benefits of the intangible assets. The second area consists of the development costs, terms of transfer, exclusivity, the degree and duration of protection by applicable laws and regulations of relevant countries, the costs and expenses of transfer, the functions and risks, and the substitutability of the intangible assets, etc.[13]

For financing, the differences should be considered in the amount, types of currency, duration, guarantee, the credit rating of the borrower, the terms of payment, and the methods of interest calculation.[14]

For the provision of services, the differences should be considered in the nature of the service, technical requirements, professional proficiencies, responsibilities assumed, forms and terms of payment, and direct and indirect costs.[15]

The CUP method is generally the most reliable measure of the arm's-length results if transactions are identical or if only minor, readily quantifiable differences exist. The CUP method is applicable to all types of related party transactions. However, it is often difficult to find comparable transactions between unrelated third parties since minor differences in the property transferred in the related and unrelated party transactions can have a material affect on price even though the business activities associated with the transactions are sufficiently similar to generate the same overall profit margin.

[11] Article 23(1) of Guo Shui Fa [2009] No. 2.

[12] Article 23(2) of Guo Shui Fa [2009] No. 2.

[13] Article 23(3) of Guo Shui Fa [2009] No. 2.

[14] Article 23(4) of Guo Shui Fa [2009] No. 2.

[15] Article 23(5) of Guo Shui Fa [2009] No. 2.

11.4.2 RESALE PRICE METHOD

RPM refers to the pricing method based on the resale price at which the goods purchased from related parties are sold to non-related parties minus the gross margin derived from identical or similar transactions.[16] The arm's-length purchase price in RPM is computed in the following formula:[17]

$$\begin{aligned}&\text{Arm's length purchase price}\\&\quad= \text{Resale price to unrelated parties}\\&\qquad\times\left(1-\text{Gross margin of comparable unrelated party transaction}\right)\end{aligned}$$

$$\begin{aligned}&\text{Gross margin of comparable unrelated party transaction}\\&\quad= \text{Gross profit of comparable unrelated party transaction}\\&\qquad\div \text{Net sales of comparable unrelated party transaction}\times 100\%\end{aligned}$$

RPM also depends on the comparability of functions performed. It may become less reliable when there are differences between the controlled and uncontrolled transactions and the parties to the transactions, and those differences have a material effect on the attribute being used to measure the arm's-length conditions. Therefore, the comparability analysis should be made by examining the differences between the related party transactions and unrelated party transactions in functional and risk profiles, contractual terms, and other factors that might impact the gross margin. These factors include sales, marketing and service functions; inventory risk; value and useful life of machinery and equipment; value and use of intangible property, retail, or sales channels; business experiences; accounting treatments; and management efficiency. Where there are material differences between the related party transaction and unrelated party transaction, reasonable adjustments to gross margin should be made to account for such differences. If a reasonable adjustment is infeasible, other reasonable transfer pricing methods should be used. RPM is usually applicable to situations where resellers do not provide materially value-added processing such as change of shape, function, structure, and trademark of products, but only conduct simple processing activities or pure resale of goods.[18]

11.4.3 COST-PLUS METHOD

CPLM refers to the pricing method based on cost-plus reasonable expenses and profit margin.[19] Under CPLM, the arm's-length price for related party transaction is the

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[16] Article 111(2) of the CIT Implementation Rules.

[17] Article 24 of Guo Shui Fa [2009] No. 2.

[18] Article 24 of Guo Shui Fa [2009] No. 2.

[19] Article 111(3) of the CIT Implementation Rules.

reasonable cost of the related party transaction plus the gross profit of a comparable unrelated party transaction. The formula is as follows:[20]

$$\begin{aligned}&\text{Arm's-length price}\\&\quad = \text{Reasonable cost of related party transaction}\\&\qquad \times \left(1 + \text{Cost plus margin of comparable unrelated party transaction}\right)\end{aligned}$$

$$\begin{aligned}&\text{Cost-plus margin of comparable unrelated party transaction}\\&\quad = \text{Gross profit of comparable unrelated party transaction}\\&\qquad \div \text{Cost of Good Sold of comparable unrelated party transaction} \times 100\%\end{aligned}$$

CPLM also depends on comparability of functions performed. Under the OECD transfer pricing guidelines, for the purposes of CPLM, an unrelated party transaction is comparable to a related party transaction only if the differences, if any, between the transactions being compared or between the enterprises undertaking those transaction do not materially affect the cost-plus margin or reasonably accurate adjustments can be made to eliminate the material effects of such differences. China transfer pricing rules take a similar approach. The tax regulations require that the comparability analysis should be made by examining the differences between the related party transactions and unrelated party transaction in functional and risk profile, contractual terms, and other factors that might impact the cost-plus margin, such as manufacturing, processing, installation, and testing functions, market and foreign exchange risk, the value and useful life of machinery and equipment, the use and value of intangible property, business experiences, accounting treatments, and management efficiency. Where there are material differences between the related party transaction and unrelated party transaction, reasonable adjustments to the cost-plus margin should be made to account for such differences. If a reasonable adjustment is infeasible, other reasonable transfer pricing methods should be used. CPLM is usually applicable to the purchase/sale, transfer, and use of tangible properties between related parties, the provision of services by related parties, and related party financing.[21]

11.4.4 TRANSACTION NET MARGIN METHOD

TNMM refers to the method whereby the profit is based on the net profit level achieved from identical or similar business transactions conducted between unrelated parties.[22]

[20] Article 25 of Guo Shui Fa [2009] No. 2.

[21] Article 25 of Guo Shui Fa [2009] No. 2.

[22] Article 111(4) of the CIT Implementation Rules.

The profit level indicators include return on assets, return on sales, full cost-plus rate[23], Berry Ratio,[24] and so forth.[25]

The tax regulations require that the comparability analysis should be made by examining the differences between the related party transactions and unrelated party transaction in functional and risk profiles, economic environment, and other factors that might impact the operating profit, such as functions performed, risks assumed, assets employed, industry and market condition, business scale, economic cycle, product life cycle, and the allocation of cost, expenses, earnings, and assets among transactions, accounting treatments, and management efficiency. Where there are material differences between the related party transaction and unrelated party transaction, reasonable adjustments to operating profit should be made to account for such differences. If a reasonable adjustment is infeasible, other reasonable transfer pricing methods should be used. TNMM is usually applicable to the purchase/sale, transfer, and use of tangible properties between related parties, the related party transfer of intangibles, and the provision of services by related parties.[26]

11.4.5 PROFIT SPLIT METHOD

PSM refers to the method whereby the consolidated profit or loss of an enterprise and its related parties are split based on reasonable criteria.[27] PSM requires that the profit be allocated to each related party according to the respective contribution of the party. There are two types of PSM, general profit split method and residual profit split method. The general profit split method splits profit among related parties according to the functions performed, risk assumed, and assets employed by each entity in the related party transactions. The residual profit split method will first identify the residual profit by deducting routine profit for each related party from the total consolidated profit; then the residual profit will be allocated according to each party's contribution to the residual profit. When applying PSM, special attention should be paid to investigating the functions performed, risk assumed, and assets employed by each related party, allocation of cost, expense, earnings, and assets between related parties involved in the transaction, accounting treatments, and reliability of the information and assumptions used to evaluate the contribution of each related party to the residual profit. PSM is usually

[23] Full cost-plus rate = Operating profit before financial expenses/(Cost of good sold + Selling expenses + G&A expenses).

[24] Berry Ratio = Gross profit/(Gross profit−Operating income before financial expenses).

[25] Article 26 of Guo Shui Fa [2009] No. 2.

[26] Article 26 of Guo Shui Fa [2009] No. 2.

[27] Article 111(5) of the CIT Implementation Rules.

applied in cases where the related party transaction is highly integrated and it is difficult to evaluate the operating result in isolation.[28]

11.5 Reporting and Contemporaneous Documentation

11.5.1 Annual Filing

The CIT Law requires that when an enterprise files its annual CIT return, it submit a form for annual reporting of related party transactions along with its annual CIT return.[29] The form, Annual Report for Related Party Transactions for Enterprise,[30] comprises nine forms. An enterprise is required to list each related party, including name, taxpayer identification number, country, address, legal representative, and the type of related party (e.g., by ownership, the control of board or management, the control of sales) with which the enterprise has had transactions for the filing year. The enterprise is also required to report each category of related party transactions, including product purchase, product sales, service income, service expenses, purchase of intangibles, sales of intangibles, sales of fixed assets, purchase of fixed assets, interest income, interest expenses, and various other payments to or from related parties. The enterprise also needs to disclose detailed information of equity investment in each foreign enterprise including the income statement and balance sheet of invested foreign enterprise.

11.5.2 Contemporaneous Documentation

Enterprises are required to prepare and maintain contemporaneous documents regarding related party transactions for each taxable year.[31] However, enterprises that meet one of the following conditions are exempted from preparing contemporaneous documents:[32]

(1) The annual amount of related party purchase and sales is no more than RMB200 million and the annual amount of other related party transactions is no more than RMB40 million. For contract processing activities, the amount of purchase and sales is calculated based on the import and export customs declaration prices. For related party financing, the amount of transaction is the amount of interest received and paid. The determination of the amount of related party

[28] Article 27 of Guo Shui Fa [2009] No. 2.

[29] Article 43 of the CIT Law.

[30] Guo Shui Fa [2008] No. 114, issued by the SAT on December 5, 2008.

[31] Article 114 of the CIT Implementation Rules; Article 13 of Guo Shui Fa [2009] No. 2.

[32] Article 15 of Guo Shui Fa [2009] No. 2.

transaction for this purpose excludes the amount covered by cost sharing agreement or advance price agreement effective in that year;

(2) Related party transactions are covered under effective advance pricing agreement; or

(3) An enterprise with foreign equity interest of 50 percent or lower and the related party transactions only incur among enterprises within China.

The Implementation Rules for Special Tax Adjustments provide detailed requirements for contemporaneous documentation on related party transactions. The documents required mainly include the following:[33]

(1) Organizational structure. The documentation regarding organizational structure should include: (1) the organizational structure of the group that the enterprise is affiliated with, and the shareholding structure of the group; (2) the development and change of relationships between the enterprise and its related parties; (3) the information of related parties with which the enterprise conducted transactions, including the name, legal representative, directors and senior management personnel, registered address and place of actual business of the related enterprises, and the name, nationality, residency, and family members of the related individuals, identifying the parties that had direct influence on the pricing of the related party transactions; and (4) the income tax information of each related party, including types of tax, tax rates, and eligible tax incentives.

(2) Overview of business operations. The documentation regarding business operations of the enterprise should include: (1) the summary of the business of the enterprise, including an overview of development of the enterprise, industry brief, business strategy, the major economic and legal issues affecting the enterprise and the industry such as industry policies and restrictions, and the group supply chain and the position of the enterprise in the supply chain; (2) the composition of the main business of the enterprise, the revenue of the main business and its percentage in the enterprise's total revenue, and the profit of the main business and its percentage of the total profits of the enterprise; (3) the analysis of position of the enterprise within the industry and the analysis of relevant market competition environment; (4) the internal organizational structure of the enterprise, the information concerning functions performed, risks assumed, and assets employed by the enterprise and related parties in related party transactions. A form, Functional and Risk Analysis for Enterprise, should be completed accordingly; and (5) the group's consolidated financial

[33] Article 14 of Guo Shui Fa [2009] No. 2.

statements which may be subsequently prepared according to the fiscal year of the group but should be prepared and included no later than December 31 following the related party transaction year.

(3) Related party transactions. The information of related party transactions should include: (1) the types, participants, timing, amount, settlement currency, and contractual terms of the related party transactions; (2) the transaction model, any changes during the year, and the reasons for such change; (3) the operational flows of related party transaction, including information flow, flow of goods, and cash flow of each step of the transaction and the flow comparison between related party transactions and unrelated party transactions; (4) the intangible assets involved in related party transactions and their impact on pricing; (5) the copies of contracts for related party transactions and a description of contract implementation status; (6) an analysis of major economic and legal factors that impact the pricing for related party transactions; and (7) the allocation of revenues, costs, expenses, and profits between related party transactions and unrelated party transactions. If these cannot be directly allocated, a reasonable apportionment can be made and the percentage of apportionment and reasons should be provided. A form, Annual Financial Analysis on Related Party Transactions for Enterprises, should be completed accordingly.

(4) Comparability analysis. Comparability analysis should include: (1) factors considered in the comparability analysis, including the characteristics of assets and services involved in the transaction, the functions performed and risks assumed by each party to the transaction, contract terms, economic environment, and business strategies; (2) the information concerning functions performed, risks assumed, and assets employed by comparable enterprises; (3) the descriptions of comparable transactions including, for example, for tangible assets: the physical characteristics, quality, and efficacy of the assets; for financing activities: interest rates, amount of financing, currency, duration, guarantees, credit ratings, terms of repayment, and methods of interest computation; for services: the nature and extent of services; for intangibles: the types of assets and forms of transaction, and the right and benefits of using the intangible assets acquired from the transaction; (4) the source, selection criteria and rationale for the comparable information; and (5) adjustments to comparable data and the reasons for such adjustments.

(5) Transfer pricing methods. The documentation regarding the selection and application of transfer pricing methods should include: (1) the selection of transfer pricing method and the reasons for such selection; if an enterprise selects the profit-based method, it must explain its contribution to group overall profit or residual profit; (2) how comparable data can support the selection of transfer pricing method; (3) the assumptions and judgments made

in determining the price or profits of comparable uncontrolled prices or profits; (4) the determination of the price and profits of comparable uncontrolled prices or profits by applying reasonable transfer pricing methods and the results of the comparability analysis and justification that such determination is in compliance with the arm's length principle; and (5) other information to support selected transfer pricing methods.

Enterprises should complete the contemporaneous documentation on or before May 31 following the year in which the related party transactions take place.[34] The completion of contemporaneous documentation for related party transactions for 2008, however, can be postponed to December 31, 2009.[35] The document should be prepared in Chinese. If the original documents are in a foreign language, a Chinese translation should be provided.[36] Upon the request of tax authorities, an enterprise should submit the contemporaneous documents within twenty days.[37] The documents submitted to the tax authorities must be affixed with a corporate seal of the enterprise and signed by the legal representative of the enterprise or a person authorized by the legal representative. The source of cited information in the documents should be indicated.[38] Enterprises should retain the contemporaneous documentation for ten years from June 1 following the transaction year.[39] If an enterprise changes its tax registration or performs tax de-registration due to a merger or de-merger, the surviving enterprises should maintain the pre-reorganization contemporaneous documentation.[40]

11.6 Transfer Pricing Audit and Adjustment

The Implementation Rules for Special Tax Adjustments provide the procedures and requirements of transfer pricing investigations conducted by the tax authorities. According to the Implementation Rules for Special Tax Adjustments, the following enterprises will be key targets of transfer pricing audits:[41]

(1) Enterprises that have a large volume or many types of related party transactions or have multiple types of related party transactions;

[34] Article 16 of Guo Shui Fa [2009] No. 2.
[35] Article 116 of Guo Shui Fa [2009] No. 2.
[36] Article 19 of Guo Shui Fa [2009] No. 2.
[37] Article 16 of Guo Shui Fa [2009] No. 2.
[38] Article 17 of Guo Shui Fa [2009] No. 2.
[39] Article 20 of Guo Shui Fa [2009] No. 2.
[40] Article 18 of Guo Shui Fa [2009] No. 2.
[41] Article 29 of Guo Shui Fa [2009] No. 2.

(2) Enterprises that report losses, marginal profits, or fluctuating profits for extended periods;
(3) Enterprises whose profit margins are lower than those of other enterprises in same industry;
(4) Enterprises whose profit margins are obviously inconsistent with the functions performed and risk assumed;
(5) Enterprises that transact with related parties established in tax havens;
(6) Enterprises that fail to file or prepare required contemporaneous documentation; and
(7) Enterprises that are otherwise obviously not in compliance with the arm's-length principle.

The tax authorities may conduct desktop audits and field audits. A desktop audit usually is selected and conducted as part of daily tax collection and administration of the tax authorities. The desktop audit is to make an overall evaluation and analysis of an enterprise's production and operational status and related party transactions mainly based on the enterprise's historical annual tax returns, related party transactions reporting forms, and other tax related documents. The tax authorities may request that enterprises provide contemporaneous documents during desktop audits.[42] For a field audit, the tax authorities must issue formal Notice of Tax Audit to the taxpayer. The field audit may include inquiry, review of accounting books and records, and on-site investigation.[43] The tax authorities may, during a transfer pricing audit, request that the audited enterprise, related parties, and other parties that are relevant to the related party transactions provide information. The tax authorities may verify the information provided by the audited enterprise, related parties, and comparable enterprises through approaches such as field investigation, assistance from other tax authorities via letter request, and searching information from public sources. If overseas information is needed, the tax authorities may either initiate the information exchange procedures specified in the relevant tax treaties or investigate the collected relevant information through the overseas organizations of Chinese government. The tax authorities may request that the information related to overseas-related parties be notarized by public notary.[44] The tax authorities may use both public and non-public information when analyzing the related party transactions.[45]

Where the related party transactions of an enterprise are proved to be in line with the arm's length principle after an audit, the tax authorities should conclude the tax audit and

[42] Article 31 of Guo Shui Fa [2009] No. 2.
[43] Article 32 of Guo Shui Fa [2009] No. 2.
[44] Article 36 of Guo Shui Fa [2009] No. 2.
[45] Article 37 of Guo Shui Fa [2009] No. 2.

issue a Notice on Special Tax Audit Conclusion to the enterprise.[46] Where the tax audit reveals that an enterprise's related party transactions are not in line with the arm's-length principle and result in reduction of taxable revenue or taxable income, the tax authorities can make a transfer pricing adjustment. The tax authorities should first propose a preliminary tax adjustment plan based on the calculation, evaluation, and comparability analysis made by the tax authorities. The tax authorities should then consult and discuss the preliminary adjustment plan with the taxpayer. Where the enterprise disagrees on the preliminary adjustment plan, it should provide further information during the period set by the tax authorities. The tax authorities will verify the information carefully and make timely deliberation and decision. The tax authorities then will issue a Preliminary Special Tax Audit Adjustment Notice. If the enterprise disagrees with the preliminary adjustment notice, it must inform the tax authorities in writing within seven days of receiving the notice. The tax authorities should negotiate and deliberate again after receiving the enterprise's submission. If the enterprise does not submit the written reply within the time limit, the enterprise may be deemed to have agreed with the preliminary adjustment notice. Finally, the tax authorities will make a final determination of final adjustment and issue a Special Tax Audit Adjustment Notice to the enterprise.[47] The enterprise must pay the tax and interests due within the specified period after receiving the Special Tax Audit Adjustment Notice.[48] If the enterprise disagrees with the adjustment, it may proceed with review and appeal process. The procedures of review and appeal are discussed in Chapter 15.

The Implementation Rules for Special Tax Adjustments provide specific guidance to transfer pricing tax audit and adjustment for some special situations. Where the related party transactions are between domestic parties with the same actual tax rate, in principle, the tax authorities should not conduct a transfer pricing audit or make a transfer pricing adjustment, as long as the transaction does not directly or indirectly result in the reduction of tax revenue as a whole.[49] When the tax authorities analyze and evaluate an enterprise's related party transactions, in principle the difference in operating profit caused by operating assets differences between the enterprise and the comparable enterprises should not be adjusted. If an adjustment is necessary, it must be reported to and approved by the SAT.[50] If an enterprise engages in processing manufacturing under the orders of related parties and does not perform functions such as operational decision making, product R&D, and sales, the enterprise should not bear the risks and losses associated with the wrong decisions, low capacity utilization, or sluggish sales, and should normally maintain

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[46] Article 42 of Guo Shui Fa [2009] No. 2.

[47] Article 43 of Guo Shui Fa [2009] No. 2.

[48] Article 44 of Guo Shui Fa [2009] No. 2.

[49] Article 30 of Guo Shui Fa [2009] No. 2.

[50] Article 38 of Guo Shui Fa [2009] No. 2.

a certain level of profit. If such enterprise incurs loss, the tax authorities should select appropriate comparable prices or comparable enterprises to determine a profit level based on economic analysis.[51] Where payments between an enterprise and its related parties are offset, the tax authorities will in principle restore the transactions and evaluate each related party transaction separately when conducting a comparability analysis and making adjustments.[52] When the tax authorities analyzes and evaluates the profitability of an enterprise by using the quartile method, if the profit level of the enterprise is lower than that the median of the range of profitability established by comparable enterprises, in principle the tested enterprise's profit should be adjusted to a level not lower than the median of the range established by the comparable enterprises.[53]

If the tax authorities make a tax adjustment for an enterprise as a result of a transfer pricing audit, the enterprise will be placed on the watch list for a five-year follow-up supervision period following the last adjustment year. During this follow-up supervision period, the enterprise is required to submit contemporaneous documentation for each year to the tax authorities on or before June 20 after each year-end. The tax authorities will analyze and evaluate the following key contents based on the contemporaneous documents and tax filing information:

(1) The investment and business operation conditions of the enterprise and their changes;
(2) The changes in amount of tax reported by the enterprise;
(3) The changes in the result of business operations of the enterprise; and
(4) The changes in related party transactions of the enterprise.

During the follow-up supervision period, if the transfer pricing of the enterprise is found abnormal, the tax authorities will communicate with the enterprise in time manner and request that the enterprise make self-adjustments, or conduct transfer pricing audit and adjustment.[54].

11.7 Advance Pricing Arrangement (APA)

An APA is a binding agreement between a taxpayer and the tax authorities to apply an agreed-upon transfer pricing methodology to specified transactions between the taxpayer and related parties. An APA is intended to resolve potential transfer pricing disputes in advance and to provide taxpayers with some certainty in planning their affairs. Based on

[51] Article 39 of Guo Shui Fa [2009] No. 2.
[52] Article 40 of Guo Shui Fa [2009] No. 2.
[53] Article 41 of Guo Shui Fa [2009] No. 2.
[54] Article 45 of Guo Shui Fa [2009] No. 2.

the number of jurisdictions involved, APAs can be classified into three types: unilateral, bilateral, and multilateral. A unilateral APA refers to an arrangement solely between a taxpayer or taxpayers of a country and the tax administration of the country. A bilateral APA is based on the mutual agreement between the competent authorities of two tax administrations under the relevant treaty. A multilateral APA refers to the situation where there is more than one bilateral mutual agreement.

The SAT has set forth procedures for obtaining an APA in the Implementation Rules for Special Tax Adjustments. An enterprise may apply for an APA if (1) its annual related party transactions total RMB40 million or more; (2) it has performed related party transaction filings in compliance with the law; and (3) it has prepared, maintained, and submitted contemporaneous documentation in accordance with the regulations.[55] An APA should be applied with the tax authorities at the level of city (with districts) and autonomous prefecture or above.[56] If an APA involves tax authorities in two or more different provinces, autonomous regions, municipalities, or cities specifically designated in the state plan or involving both state tax bureaus and local tax bureaus, the SAT will organize and coordinate the negotiation and implementation of APA; the enterprise can express the intent of the APA in writing directly to the SAT.[57] An APA generally applies to related party transactions occurring during the three to five consecutive years after the year in which the formal APA application is filed. The signing of an APA will not affect the tax authorities' transfer pricing audit and adjustment of related party transactions for the years prior to the application filing. However, if the related party transactions in the filing year or prior years are the same or similar to those covered in the APA, the pricing principle and calculation method adopted in the APA can be retroactively applied to the filing year or prior years upon the approval of the tax authorities.[58] An APA automatically expires at the end of the APA term. The enterprise may apply for renewal of an APA ninety days prior to the expiration date of the APA.[59] Both the tax authorities and the enterprise should keep confidential all the information obtained during the APA process.[60] If the tax authorities and the enterprise fail to reach an APA, the non-factual information related to the enterprise such as proposals, reasoning, notions and judgments obtained during the discussion and negotiation should not be used later in tax audits of the transactions covered by the aborted APA.[61]

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[55] Article 48 of Guo Shui Fa [2009] No. 2.

[56] Article 47 of Guo Shui Fa [2009] No. 2.

[57] Article 58 of Guo Shui Fa [2009] No. 2.

[58] Article 49 of Guo Shui Fa [2009] No. 2.

[59] Article 57 of Guo Shui Fa [2009] No. 2.

[60] Article 60 of Guo Shui Fa [2009] No. 2.

[61] Article 61 of Guo Shui Fa [2009] No. 2.

An APA normally consists of six steps including pre-filing meetings, formal application, review and evaluation, negotiations, the signing of agreement, and implementation and monitoring.[62]

Step 1: Pre-filing agreement.

Prior to formally applying for an APA, an enterprise should request in writing for a pre-filing meeting. Upon such request, the tax authorities and the enterprise will conduct a meeting to discuss the feasibility of an APA. A pre-filing meeting may be conducted on an anonymous basis. The pre-filing discussions should cover (1) the tax years to be covered by the APA; the related parties and the transactions to be covered in the APA; (3) the business operation of the enterprise in prior years; (4) the functional and risk analysis of related parties in the APA; (5) whether to retroactively apply the APA methodologies to resolve issues in prior years; and (6) other issues that require explanation.[63]

If an enterprise plans to apply for a bilateral or multilateral APA, the enterprise should make the pre-filing request to both the SAT and the tax authority in charge. The SAT will arrange for the pre-filing meeting. The discussions in a pre-filing meeting should cover, in addition to those for a pre-filing meeting of unilateral APA: (1) the status of pre-filing meeting applications to the competent tax authorities of corresponding country or region involved; (2) the historical business operations and related party transactions of the related parties which are relevant to the APA; and (3) Proposed pricing principle and calculation methods to be used in the APA submitted to the competent tax authorities of the treaty country.[64]

If the tax authorities and the enterprise have reached an agreement through the pre-filing meeting, the tax authorities will issue a Notice on Formal Negotiation of APA to the enterprise within 15 days of reaching such agreement. If no agreement is reached through the pre-filing meeting, the tax authorities should, within 15 days of the last meeting, issue a Notice on Refusal of the Application of APA to deny the application, with an explanation included.[65]

Step 2: Formal application

Within three months after the enterprise has received the notice from the tax authorities with respect to starting the formal APA negotiations, the enterprise should file a Formal APA Application to the tax authorities. For a bilateral or multilateral APA, the enterprise should submit both the Formal APA Application and the Application for Initiating Mutual Agreement Procedures to the SAT and the tax authorities in charge. The application should include: (1) a relevant group organizational chart and information about company structure, related parties relationships, and related party

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[62] Article 46 of Guo Shui Fa [2009] No. 2.

[63] Article 50(1) of Guo Shui Fa [2009] No. 2.

[64] Article 50(2) of Guo Shui Fa [2009] No. 2.

[65] Article 50(3) of Guo Shui Fa [2009] No. 2.

transactions; (2) the financial statements and information of products and assets (including both intangible and tangible assets) of the enterprise for the prior three years; (3) the types of related party transactions involved and tax years to be covered by the APA; (4) the allocation of functions performed and risks assumed between each relevant related party and the basis of such allocations, such as establishments, personnel, expenses, and assets; (5) the applicable transfer pricing principles and calculation methods, the functional and risk analysis, comparability analysis and the critical assumptions that support the proposed transfer pricing principles and calculation method; (6) market conditions including future trends and competition environment of the relevant industry; (7) annual operation scale, profit and loss forecasts, and business plans for the years to be covered by the APA; (8) the information of related party transactions and business operations that are relevant to the APA and the financial information such as profit levels of such transactions and operations; (9) the issue of double taxation; and (10) any other related issues concerning relevant domestic and foreign laws and tax treaties.[66]

If the enterprise cannot submit the formal APA application within the three-month period for special reasons, the enterprise may request for an extension of time by filing an Extension for Submission of the Formal APA Application to the tax authorities. The special reasons include: (1) certain materials in particular need to be prepared; (2) there are technical issues to be addressed regarding materials to be submitted, such as translation; and (3) other non-subjective reasons. The tax authorities should issue a written replay on the extension request within 15 days of receiving the request. If the tax authorities have not replied within the prescribed period, the extension is deemed to be granted.[67]

Step 3: Review and evaluation

Within five months of receiving a formal APA application, the tax authorities in charge will review and evaluate the APA application. During this review and evaluation, the tax authorities may request for additional information. If the tax authorities need more time for review and evaluation due to special reasons, the tax authorities will notify the enterprise through Notice on Extension for APA Evaluation. The extension should not be longer than three months. The review and evaluation will mainly include the following:[68]

(1) Historical business operations. The tax authorities will analyze and evaluate documents and materials that reflect the enterprise's operational plan, future trends, and business scope with a focus on the feasibility analysis, investment budget and results, and decisions by the board of directors. The tax authorities will also conduct a comprehensive analysis of the relevant information that

[66] Article 51(1) of Guo Shui Fa [2009] No. 2.

[67] Article 51(2) of Guo Shui Fa [2009] No. 2.

[68] Article 52 of Guo Shui Fa [2009] No. 2.

reflects the enterprise's operation performance, such as financial statements and audit reports.

(2) Functions and risks. The tax authorities will analyze and evaluate the respective functions performed by the enterprise and its related parties in supply, production, transportation, sales, and R&D of intangible assets, and the risks assumed respectively with respect to inventory, credit, foreign exchange, and market.

(3) Comparable information. The tax authorities will analyze the domestic and overseas comparable pricing information provided by the enterprise to explain the material differences between the enterprise and the comparable enterprises, and adjustments should be made accordingly. If the tax authorities are unable to confirm the reasonableness of the comparable transactions or operations, the tax authorities will ask the enterprise to provide additional documents to prove that the proposed transfer pricing principles and calculation method have fairly reflected the related party transactions and the economic reality and can be supported by relevant financial and operational data.

(4) Critical assumptions. The tax authorities will analyze and assess the factors affecting the industry profitability and the production of the enterprise and the degree of influence, and determine appropriate assumptions for the APA.

(5) Transfer pricing principles and calculation method. The tax authorities will analyze and evaluate whether and how the proposed transfer pricing principles and calculation method may be accurately applied to past, current, and future related party transactions and the financial and operating results, and they are in compliance with the laws and regulations.

(6) Expected range of arm's-length price or profit. The tax authorities will estimate the range of prices or profit acceptable to both the tax authorities and the enterprise based on the further review and evaluation over the determined comparable price, profit margin, and comparable transactions.

Step 4: Negotiations

Within 30 days of forming the review and evaluation conclusions for a unilateral APA, the tax authorities should start to negotiate with the enterprise. After reaching consensus, the tax authorities should submit the draft APA and evaluation report level-by-level to the SAT for its review and approval. For bilateral and multilateral APAs, the SAT will negotiate with the competent tax authorities of the counterparty country or region, and the draft APA will be prepared according to the negotiation memorandum if consensus can be reached. A draft APA should mainly include the following provisions: (1) names, addresses, and relevant basic information about the related parties; (2) related party transactions involved and years covered; (3) the comparable prices or transactions, transfer pricing principles and calculation methods, and expected operating results adopted by the APA; (4) the definitions of terms related to the application of transfer pricing

principles and calculation methods; (5) critical assumptions; (6) the obligations of the enterprise regarding annual reporting, maintenance of relevant records, and the notification of change of assumptions; (7) validity of the APA and confidentiality of the documents and materials; (8) the responsibilities of both parties; (9) the amendment to the APA; (10) dispute resolution; (11) effective date; and (12) supplementary provisions.[69]

Step 5: Signing of agreement

For a unilateral APA, after the tax authorities and the enterprise have reached an agreement on the draft APA, the legal representatives or other persons authorized by the legal representatives of both sides will formally sign the APA. For bilateral or multilateral APA, after the SAT and the competent tax authorities of the counterparty country (or region) have reached an agreement on the draft APA, the authorized representatives of the SAT and the corresponding competent tax authorities of other jurisdiction or jurisdictions will formally sign the bilateral or multilateral APA. The local tax authorities in charge and the enterprise will sign the Implementation Agreement for Bilateral or Multilateral APA according to the bilateral or multilateral APA.[70]

Upon the commencement of the formal negotiation, either the tax authorities or the enterprise may suspend or terminate the negotiation process before the APA is signed. For bilateral or multilateral APAs, the negotiation process may be suspended or terminated subject to the consultation among tax authorities in charge of each side. If the negotiation process is terminated, the tax authorities and the enterprise will return all materials they received from each other during the negotiations.[71]

Step 6: Implementation and monitoring

The tax authorities will establish a monitoring and administrative system to monitor the implementation of the APA. During the APA implementation period, the enterprise should keep complete documents, books, and records. The enterprise should provide the tax authorities with an annual report on the implementation of the APA within five months of the tax year-end. The annual report should include a description of the operations and the status of compliance with the APA by the enterprise, including all the requirements of the APA. The annual report should also indicate whether the taxpayer wishes to revise or effectively terminate the APA. If there are certain outstanding or forthcoming issues, the enterprise should explain such issues in the annual report in order to negotiate with the tax authorities regarding whether the APA should be revised or terminated.[72]

During the APA implementation period, the tax authorities will regularly (normally every half year) inspect the implementation by the enterprise. The inspection will cover: (1) whether the enterprise has abided by the terms and requirements of the arrangement;

[69] Article 53 of Guo Shui Fa [2009] No. 2.

[70] Article 54 of Guo Shui Fa [2009] No. 2.

[71] Article 55 of Guo Shui Fa [2009] No. 2.

[72] Article 56(1) of Guo Shui Fa [2009] No. 2.

(2) whether the materials and annual report provided by the enterprise for negotiating the APA reflect the actual operations of the enterprise; (3) whether the materials and calculation method supporting the transfer pricing method are correct; (4) whether the critical assumptions are still valid; and (5) whether the application of the transfer pricing method by the enterprise is consistent with the critical assumptions. If the enterprise is found to have violations of the APA terms, the tax authorities will take necessary steps or even terminate the APA based on the circumstances. If the enterprise hides the facts or refuses to comply with the APA terms, the tax authorities should revoke the APA retroactively to the first year that the APA came into effect.[73]

During the APA implementation period, if the actual operating results of the enterprise are outside of the range of expected prices or profits, upon approval by the immediate higher-level tax authorities, the tax authorities will adjust the enterprise's operating results to ensure that the results are within the range of prices or profits as specified in the agreement. Under a bilateral or multilateral APA, the adjustments will ultimately be reported to the SAT for its review and approval.[74] During the APA implementation period, if there are any substantial changes affecting the APA, the enterprise should notify the tax authorities within thirty days of the occurrence of such changes. In the notification, the enterprise should explain in detail the impact of the substantial changes on the APA and should also attach relevant supporting materials. If the enterprise cannot report in time due to non-subjective reasons, the enterprise may request for an extension for the notification. The extension, however, will not exceed thirty days. Within sixty days after receiving the enterprise's written request, the tax authorities will evaluate such a request and take necessary steps accordingly, including reviewing the changes, negotiating with the enterprise to revise the APA terms and relevant conditions, or, based on the extent of impact of such substantial changes on the implementation of the APA, take reasonable steps to revise or terminate the APA. After the termination of the original APA, the tax authorities may re-negotiate and sign a new APA with the enterprise in accordance with the procedures and requirements of the regulations.[75]

If the APA is jointly signed by the state tax bureau, local tax bureau, and the enterprise, the enterprise should submit the annual report and the report regarding substantial changes to both the state tax bureau and the local tax bureau. The state tax bureau and the local tax bureau will jointly inspect and review the implementation of the APA by the enterprise.[76] If an APA is negotiated and signed by the enterprise with the tax authorities, as long as the enterprise abides by all the terms and requirements of the arrangement,

[73] Article 56(2) of Guo Shui Fa [2009] No. 2.

[74] Article 56(3) of Guo Shui Fa [2009] No. 2.

[75] Article 56(4) of Guo Shui Fa [2009] No. 2.

[76] Article 56(5) of Guo Shui Fa [2009] No. 2.

the state tax bureaus and the local tax bureaus of different places should all implement the arrangement.[77]

In the implementation of the APA, if there is any disagreement between the tax authorities and the enterprise, both parties should try to resolve the disputes through negotiation. If the two parties cannot resolve their disputes through negotiation, the case may be brought to the tax authorities at the higher level; where a bilateral or multilateral APA is involved, the case should be submitted, level-by-level, to the SAT, and should be coordinated by the SAT. Where the higher-level tax authorities or the SAT makes a decision, the lower level of tax authorities should accept the determination. However, if the enterprise does not accept the decision, the APA should be terminated.[78] The tax authorities shall submit an official copy of a unilateral APA, an official copy of an implementation agreement of a bilateral or multilateral APA, or report any changes of APAs to the SAT, level-by-level, for records filing, within ten days on signing the APAs or agreements with enterprises, or within twenty days on revisions or terminations of APAs.[79]

11.8 Cost-Sharing Agreement (CSA)

A CSA is a framework, agreed-upon among enterprises, to share the costs and risks of developing, producing, or obtaining assets, services, or rights, and to determine the nature and extent of the interest of each participant in those assets, services, or rights. The CIT Law allows an enterprise to reach a CSA with its related parties on the sharing of the costs incurred for the joint development or transfer of intangible assets, or for the joint provision or receipt of services based on the arm's-length principle.[80] The SAT has provided more detailed guidance on CSAs in the Implementation Rules for Special Tax Adjustments.

A CSA must satisfy the principle of matching costs with expected benefits.[81] Participants of a CSA that are entitled to the benefits of the joint development or assignment of intangible properties or participation of service activities should bear the corresponding costs of such activities. The costs borne by the related parties should be consistent with the costs spent by unrelated parties seeking those benefits under comparable circumstances. Participants to a CSA are not permitted to be required to pay royalties for intangible assets developed or acquired under the CSA[82] An enterprise's beneficial right associated with a CSA involving intangible assets or services should be based on reasonable and

[77] Article 59 of Guo Shui Fa [2009] No. 2.

[78] Article 62 of Guo Shui Fa [2009] No. 2.

[79] Article 63 of Guo Shui Fa [2009] No. 2.

[80] Article 41 of the CIT Law.

[81] Article 112 of the CIT Implementation Rules.

[82] Article 65 of Guo Shui Fa [2009] No. 2.

measurable expected returns and should be based on reasonable business assumptions and operational conventions.[83] A CSA involving services is generally applicable to group purchases and group marketing planning activities.[84]

A CSA mainly should include the following contents: (1) the names, country (region) of residence, related party relationships, and the rights and obligations of participants to the CSA; (2) the content and scope of intangible assets or services associated with the CSA and the responsibilities and tasks of participants; (3) the valid duration of the CSA; (4) the methodology and assumptions used for calculating the expected benefits for the participants; (5) the amount, form, and value determination method of the initial investment and subsequent additional costs paid by participants, as well as an explanation justifying the compliance of the arm's-length principle; (6) the accounting method adopted by the participants and explanation of changes to the accounting method; (7) the procedure for participants to join or exit the agreement; (8) the conditions and provisions for compensating payments between participants; (9) the conditions and provisions for the amendment or termination of the CSA; and (10) the provisions for the use of a CSA outcome by non-participants.[85]

CSAs must be filed and approved by the tax authorities. An enterprise should submit a CSA to the tax authorities within thirty days of concluding the CSA. The tax authorities must report level-by-level to the SAT for approval to determine whether the CSA complies with the arm's length principle.[86] Enterprises may reach a CSA in the form of an APA according to the APA procedures.[87]

If a CSA has been implemented and has generated certain assets, a change in participants or the termination of the CSA must satisfy the arm's-length principle. The new participant should make a reasonable buy-in payment for being entitled to benefit from the existing outcome. The exiting participant should receive a reasonable buy-out payment for the transfer of beneficial rights of the existing outcome to other participants. The benefits and cost sharing status of all participants will be adjusted accordingly as of any changes of participants. If a CSA is terminated, the participants should reasonably distribute the existing outcome upon the termination of CSA. If an enterprise fails to treat those events in accordance with the arm's-length principle and thus reduces its taxable income, the tax authorities have the right to make adjustments.[88]

During the implementation of a CSA, if the actual costs that the participants share do not match the actual benefits received, compensating adjustments should be made based

[83] Article 66 of Guo Shui Fa [2009] No. 2.

[84] Article 67 of Guo Shui Fa [2009] No. 2.

[85] Article 68 of Guo Shui Fa [2009] No. 2.

[86] Article 69 of Guo Shui Fa [2009] No. 2.

[87] Article 73 of Guo Shui Fa [2009] No. 2

[88] Article 70 of Guo Shui Fa [2009] No. 2.

on the actual situation.[89] If a CSA is in compliance with the arm's-length principle: (1) an enterprise can deduct the costs shared each year, in computing its taxable income, in accordance with the CSA during the effective period of the CSA; (2) the compensating adjustments shall be included in the taxable income in the year where adjustments are made; and (3) for the CSA involved in intangible properties, buy-in or buy-out payments, or the distribution upon the termination of the CSA will be treated as a purchase or disposal of assets.[90]

An enterprise participating in a CSA should prepare and maintain the contemporaneous documents as discussed in Chapter 11.5.2. During the enforcement period of the CSA, the enterprise also needs to prepare and maintain the following additional documents: (1) copies of the CSA; (2) other agreements reached among the CSA participants for the implementation of the CSA; (3) the use of the outcome from the CSA by any parties which are not participants of the CSA and the amount or form of the payment made by them for using the outcome; (4) the information about the participants joining or exiting during the taxable year, including the name of the joining and exiting parties, their country (region) of residence, the associated party relationship, and the amount and form of the buy-in payment or buy-out compensation; (5) the amendment to or termination of the CSA, including the reasons, the treatment or allocation of the existing CSA outcome; (6) the total cost and its breakdown arising from the CSA during the current taxable year; (7) the information about cost allocation to the participants during the current taxable year, including the amount, the form, and to whom the allocated costs were paid, and the amount, the form, and from whom the cost payments were received; and (8) a comparison of the expected benefit and the actual results from the CSA, and the corresponding adjustments made during the current taxable year. During the enforcement period of a CSA, enterprises should file contemporaneous documents specific to CSA with the tax authorities on or before June 20 of the following year for each taxable year regardless of whether the CSA was concluded in the form of an APA or not.[91]

The costs allocated to an enterprise under a CSA signed with its related parties will not be deductible for CIT purposes where: (1) the CSA does not have a bona fide commercial purpose or economic substance; (2) the CSA does not comply with the arm's-length principle; (3) the allocation of costs and benefits does not comply with the cost and benefit matching principle; (4) the enterprise has not filed the CSA, or prepared, maintained, and provided contemporaneous documents with respect to the

[89] Article 71 of Guo Shui Fa [2009] No. 2.

[90] Article 72 of Guo Shui Fa [2009] No. 2.

[91] Article 74 of Guo Shui Fa [2009] No. 2.

CSAs in accordance with the regulations; or (5) the enterprise's future operational period is less than twenty years from the date when the CSA is signed.[92]

11.9 Corresponding Adjustments and International Negotiation

Where a transfer pricing adjustment is made with respect to cross-border related party transactions and therefore increases the taxable income of an enterprise in one country, such unilateral tax adjustment will not automatically reduce the taxable income of the related party to the transaction in another country. As a result, the portion of profits of the transaction will be taxed by both countries. To void this double taxation, a corresponding adjustment may need to be made with respect to the taxable income of the related party in the other country and thus reduce the taxable income of the related party. Such corresponding adjustments may also apply to domestic related party transactions, as China transfer pricing rules are applicable to related party transactions within China.

China special tax adjustment rules allow corresponding adjustment in principle. If the adjustment involves a related party located in a country (region) that has entered into a tax treaty with China, the SAT may negotiate with the competent tax authorities of the treaty country (region) according to the mutual agreement procedures under the tax treaty upon the application of an enterprise.[93] If an enterprise seeks a corresponding transfer pricing adjustment involving related parties in a treaty country (region), the enterprise must file Application for Initiating a Mutual Agreement Procedure to both the SAT and the tax authority in charge, and provides related documents including copies of the transfer pricing adjustment notice to the enterprise or its related parties.[94] The application for corresponding adjustment must be made within three years from the date of the transfer pricing adjustment notice.[95] If the transfer pricing adjustment involves interest, rental, or royalties paid by an enterprise to its overseas-related parties, the withholding tax that has been paid cannot be adjusted.[96]

In Chapter 5.4, we discussed the thin capitalization rule. The interest on related party debt exceeding the permitted debt-to-equity ratio is not deductible and the excess interest paid to the related party will be reclassified as dividend. The corresponding adjustment does not apply to the transfer pricing adjustment with respect to the non-deductible interest and deemed dividends made according to the thin capitalization rule.[97]

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[92] Article 75 of Guo Shui Fa [2009] No. 2.

[93] Article 98 of Guo Shui Fa [2009] No. 2.

[94] Article 99 of Guo Shui Fa [2009] No. 2.

[95] Article 100 of Guo Shui Fa [2009] No. 2.

[96] Article 101 of Guo Shui Fa [2009] No. 2.

[97] Article 104 of Guo Shui Fa [2009] No. 2.

In July 2005, the SAT issued the Provisional Measures for Applications by Chinese Residents (Nationals) for Launching Tax Negotiation Procedures.[98] One of the situations where a Chinese resident may apply for launching tax negotiation procedures with a treaty country or region is if the transfer pricing adjustment for related party transactions may result in or has resulted in double taxation by the tax authorities in different jurisdictions.[99] According to the procedures, an applicant should provide the SAT with various information, including, among others, the basic information about the applicant in China and the treaty country, the name and address of the tax authority in charge in both countries, the factual information of the case (country, parties, activities, tax year, type of incomes, type of tax, amount of tax and the relevant articles and paragraphs in the tax agreement and laws), the key points of dispute, the respective opinions on the dispute of both applicant and the competent authority of the other jurisdiction and legal basis, and other supporting materials.[100]

After the preliminary review, the SAT will review as to whether the application meets the requirements for mutual agreement as provided by the applicable treaty. If the requirements are satisfied, the SAT will carry out negotiations with the competent authority of the other contracting country (region). If the application cannot meet the requirements, the SAT will so notify the applicant via the tax authority in charge. If supplemental materials are needed in order to start the tax negotiations, the SAT may request, either directly or through the tax authority in charge, that the applicant provide additional information.[101] Once the negotiation leads to a result, the SAT shall notify the applicant in writing through the tax authority in charge.[102]

11.10 Penalties, Interest, and Statute of Limitation

If an enterprise fails to file annual related party transaction schedules or retain contemporaneous documentation in accordance with the Implementation Rules for Special Adjustment, the tax authorities may impose a fine of up to RMB2,000 or, in serious circumstances, a fine of between RMB2,000 and RMB10,000.[103] If an enterprise refuses to provide related party transaction information or provides false or incomplete information, the tax authorities may impose a fine of up to RMB10,000 or, in serious circumstances, a fine of between RMB10,000 and RMB50,000.[104] The Law of Administration of Tax

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[98] Guo Shui Fa [2005] No. 115, issued by the SAT on July 7, 2005 and effective on July 1, 2005.

[99] Article 7(2) of Guo Shui Fa [2005] No. 115.

[100] Article 10 of Guo Shui Fa [2005] No. 115.

[101] Article 12 of Guo Shui Fa [2005] No. 115.

[102] Article 13 of Guo Shui Fa [2005] No. 115.

[103] Article 105 of Guo Shui Fa [2009] No. 2; Articles 60 and 62 of the Law of Administration of Tax Collection.

[104] Article 106 of Guo Shui Fa [2009] No. 2; Articles 70 of the Law of Administration of Tax Collection.

Collection imposes a penalty of 50 percent to 500 percent of the tax underpaid in tax evasion cases.[105] The tax authorities can potentially impose such penalty where taxpayers provide false information for the purpose of tax evasion.

When the tax authorities make special tax adjustments, including transfer pricing adjustments, and assess additional tax liability on transactions occurring on or after January 1, 2008, interest will be imposed, on a daily basis, upon the underpaid taxes. The interest rate is the RMB base-lending rate published by the People's Bank of China in the year(s) to which the underpaid tax relates for a loan of the same term as the period for which additional tax is payable, plus 5 percent. The interest charging period begins from June 1, the year following the tax year to which the tax is attributed until the date of tax payment. The daily interest rate is calculated based on the above annual rate, assuming 365 days per year. If an enterprise provides contemporaneous documentation and other information in accordance with the tax regulations or is exempted from preparation of contemporaneous documentation under the Implementation Rules for Special Adjustments, the interest rate should be reduced to the base-lending rate. The interest charged on the additional tax cannot be deducted in computing taxable income.[106]

Under the Law of Administration of Tax Collection, a late payment charge at a daily rate of 0.05 percent (i.e., an annual rate of 18.25 percent) on the underpayment is imposed from the date that tax is due and payable.[107] It appears that such a late payment charge does not apply to transfer pricing tax adjustments before the required additional tax payment date as a result of a transfer pricing adjustment. Instead, only interest applies to those periods. However, if an enterprise fails to pay the additional tax and interest without an approved extension, the tax authorities will impose a late payment charge on the additional tax and interest from the due date.[108]

The statute of limitation for transfer pricing adjustments is ten years. Where related party transactions do not conform to the arm's-length principle, the tax authorities have the right to make a tax adjustment within ten years of the year during which the transactions took place.[109]

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[105] Article 63 of the Law of Administration of Tax Collection.

[106] Article 107 of Guo Shui Fa [2009] No. 2.

[107] Article 32 of the Law of Administration of Tax Collection.

[108] Article 109 of Guo Shui Fa [2009] No. 2.

[109] Article 123 of the CIT Implementation Rules.

12

WITHHOLDING OF TAX AT SOURCE

12.1 Income not Effectively Connected with Establishment in China

One type of income subject to withholding tax is China-sourced income derived by a non-resident enterprise that does not have an establishment or place of business in China or that has an establishment or place of business in China but whose income is not effectively connected with such establishment or place of business.[1] Typically, income of this kind includes interest, dividends, royalties, rent, and gains on transfer of property. CIT payable by a non-resident on this type of income will be withheld at source. The payer is the withholding agent. In case of dividends, interest, rentals, and royalties, the taxable income is the entire amount of revenue,[2] which is the total consideration and other charges received by a non-resident enterprise from a payer.[3] As such, any fees and charges, including indirect taxes on the gross payment, will not be deductible in computing CIT on this type of income. In case of capital gains from transfer of properties, the taxable income is the entire amount of revenue less net property value (tax basis).[4] As such, other than the tax basis, the fees and charges on the transfer proceeds such

[1] Articles 3 and 37 of the CIT Law.

[2] Article 19(1) of the CIT Law.

[3] Article 103 of the CIT Implementation Rules.

[4] Article 19(2) of the CIT Law.

as Business Tax, broker fees, and professional fees are not deductible in computing CIT. The MOF and the SAT specifically confirm that except for the allowable deduction expressly stated in the CIT Law and the CIT Implementation Rules, no expenses and taxes can be deducted in computing the withholding tax.[5]

When income is subject to tax at source, the payer usually will be the withholding agent.[6] Payer is an entity or individual who is directly liable to a non-resident enterprise for the payment of all relevant amounts in accordance with laws and contracts.[7]

When a withholding agent enters into a contract for the first time with a non-resident enterprise where the withholding agent is required to pay interest, dividends, rentals, royalties, proceeds on the transfer of property, and other income subject to CIT, the withholding agent should perform a tax withholding registration with the tax authority in charge within thirty days of signing the contract.[8] Each time a withholding agent enters into this type of contract with a non-resident enterprise or amends the contract, concludes a supplementary contract, or extends the contract period, the withholding agent should file a Contract Registration Form for Corporate Income Tax Withholding, together with a copy of contract and other relevant documents. If the contract is in a foreign language, the Chinese translation must be provided.[9] The withholding agent should set up books and records for contract and tax withholding and accurately record tax withholdings. Such books and records can be examined by the tax authorities.[10]

Each time a withholding obligor pays or is due to pay an income of above type to a non-resident enterprise, the withholding agent is obligated to withhold tax from the payment. This withholding obligation occurs at the earlier of (1) an actual payment made to a non-resident enterprise and (2) when the payer accrues a sum of a payable as costs or expenses in accordance with accounting principle. The withholding agent should file Corporate Income Tax Withholding Report and relevant materials, and deposit the tax withheld with the State treasury within seven days of the withholding date.[11] This withholding on an accrual basis requires that a payer make a CIT payment on behalf of a non-resident enterprise regardless of whether the payer will actually pay the amount to the non-resident enterprise. Enterprises are reluctant to make such withholding tax deposits on an accrual basis in some situations. Suppose a foreign parent company makes

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[5] The Notice on Issues Concerning Collection of Corporate Income Tax for Non-resident Enterprises, Cai Shui [2008] No. 130, issued by the MOF and the SAT on September 25, 2008 and effective on January 1, 2008.

[6] Article 37 of the CIT Law.

[7] Article 104 of the CIT Implementation Rules.

[8] Articles 3 and 4 of the Provisional Measures for Administration of Corporate Income Tax Withholding for Non-resident Enterprises, Guo Shui Fa [2009] No. 3, issued by the SAT on January 9, 2009 and effective on January 1, 2009.

[9] Article 5 of Guo Shui Fa [2009] No. 3.

[10] Article 6 of Guo Shui Fa [2009] No. 3.

[11] Article 7 of Guo Shui Fa [2009] No. 3.

a loan to its Chinese subsidiary and interest is due and payable annually on December 31 each year under the loan agreement. The subsidiary should pay withholding tax on the interest on or before January 7 following the year-end, regardless of whether the subsidiary actually makes the interest payment. Suppose the subsidiary is not able to pay the interest due to cash flow problems and subsequently the loan is forgiven or converted into equity; the interest has never been paid. It would be difficult for the foreign company or the subsidiary to claim a refund for the withholding tax on interest paid.

The amount of tax withholding is taxable income multiplied by applicable tax rate. The taxable income of dividend, interest, rentals, and royalties is the gross amount of the payment item without deduction of any charges and taxes. The taxable income for transfer of properties is the net gain of gross receipts less tax basis of the property.[12] If a payer is required to pay a net sum of China income tax under a contract or agreement, the payer must gross-up the net payment, and the taxes borne by the payer will be treated as part of gross income subject to CIT.[13] The applicable CIT rate is the lesser of the rate provided by domestic tax regulations and that prescribed by applicable tax treaty or tax arrangement.[14]

When an applicable tax treaty rate is lower than the domestic rate, to enjoy the treaty benefits, the non-resident must apply for such benefits. The procedures of application for treaty benefits are discussed in Chapter 10.12. If the non-resident has not applied for the treaty benefit, the domestic tax rate will be used.[15] Similarly, where the non-resident enterprise is eligible for deduction or exemption pursuant to the CIT Law, the CIT Implementation Rules or other relevant tax regulations, the non-resident enterprise should apply for such incentives in accordance with relevant administrative measures and approval procedures. Before such approval is obtained, the withholding agent should withhold and pay CIT at domestic tax rate.[16] If the non-resident enterprise obtains the approval for a deduction and exemption under domestic regulations or tax benefits under the applicable tax treaty after tax is withheld and paid at the regular domestic rate, the non-resident enterprise may apply for a tax refund for the tax overpayment.[17] For contracts involving multiple payments, the withholding agent shall, within 15 days prior to making the last payment stipulated in the contract, submit to the tax authority such materials as the details of all payments under the contract, the withholding forms for prior payments, the tax payment certificates, and the completed tax clearance procedures.[18] If there are several locations for the transaction, the non-resident enterprise may select one location

[12] Article 8 of Guo Shui Fa [2009] No. 3.

[13] Article 10 of Guo Shui Fa [2009] No. 3.

[14] Article 8 of Guo Shui Fa [2009] No. 3.

[15] Article 12 of Guo Shui Fa [2009] No. 3.

[16] Article 11 of Guo Shui Fa [2009] No. 3.

[17] Article 13 of Guo Shui Fa [2009] No. 3.

[18] Article 18 of Guo Shui Fa [2009] No. 3.

for which to file the tax return. The tax bureau that receives the tax return and tax payment should notify the withholding agent and the tax authorities in the other locations of the tax filing and payment.[19]

Where a non-resident enterprise refuses to allow tax withholding, the withholding agent should temporarily suspend payment to the non-resident enterprise of an amount equal to the taxes due, and report to the tax authority in charge within one day, including a written explanation of the circumstances.[20] Where the withholding agent fails or is unable to withhold CIT, the non-resident enterprise should file the tax return and pay CIT by itself within seven days after the date of payment or the date of the amount due and payable. The non-resident should file the return with the tax authority where the transaction takes place.[21]

In some situations, the tax authority in charge of the withholding agent and the tax authority in charge of the tax filing of a non-resident may not be the same. For example, if a non-resident owns a rental property in one district and the lessee/withholding agent is located in another district, the tax return should be filed with the tax authority where the property is located. Where the tax authority in charge of the withholding agent and the tax authority in charge of the location where the income was accrued are different tax bureaus, the tax authority in charge of the withholding agent shall, within five working days of confirming that withholding obligor has failed or is unable to withhold tax, notify the tax authority in charge of the income locality of the non-resident enterprise tax filing issue. If the non-resident enterprise fails to file CIT return and pay CIT within 15 days, the tax authority in charge of the tax filing location will request that the non-enterprise pay the tax with a specified deadline. If the non-resident enterprise fails to pay tax within such time limit, the tax authority in charge of filing location may collect and verify information relevant to other income and payers of the non-resident enterprise in China. The tax authority may request that the other payers withhold the unpaid tax from the payments for other activities due to the non-resident enterprise. Where other payers are not in the territory charged by the tax bureau, the tax authority in charge of the locality of the other payers will assist the first tax bureau in such tax collection.[22]

Where a non-resident enterprise transfers its equity interest in a resident enterprise to another non-resident enterprise and the transfer occurs outside China, the non-resident enterprise buyer does not have an obligation to withhold CIT from sale price. The non-resident seller should pay CIT to the tax authority in charge of the resident enterprise whose equity was transferred. The tax can be paid either directly by the non-resident

[19] Article 16 of Guo Shui Fa [2009] No. 3.

[20] Article 14 of Guo Shui Fa [2009] No. 3.

[21] Article 15 of Guo Shui Fa [2009] No. 3.

[22] Article 17 of Guo Shui Fa [2009] No. 3.

seller or by an agent on its behalf. The resident enterprise whose equity was transferred should assist the tax authority in collecting taxes from the non-resident enterprise.[23]

12.2 Interest Paid to Foreign Bank and Foreign Branch

Prior to 2008, although interest income derived by foreign banks from China should have been subject to 10 percent withholding tax, inter-bank interest paid to foreign financial institutions was practically exempted from such tax. On and after January 1, 2008, Chinese financial institutions are required to withhold CIT on interest payment to foreign banks. Foreign-funded financial institutions located in China are also required to withhold CIT on outbound interest payment.[24] Furthermore, institutions within China should also withhold CIT on interest paid to overseas branches of Chinese banks in accordance with the CIT Law and the CIT Implementation Rules.[25]

12.3 Income of Foreign Service Providers

Another type of income subject to withholding tax is the income derived by a non-resident enterprise from the performance of engineering work and the provision of other services within China. The tax authorities may designate the payer of service fee as the withholding agent.[26] As discussed in Chapter 3.3.2, a foreign contractor that has an establishment or place of services in China will be subject to CIT on the business profit derived from the establishment or place of business. The foreign contractor in such a situation is actively conducting a trade or business within China and should register with and pay CIT, if any, directly to the tax authorities. In spite of the primary obligation of CIT filing of foreign service providers, the tax authorities may designate the payer as a withholding agent in one of the following situations: (1) where the work on a project or the provision of services is projected to last less than a year, and there is evidence of non-fulfillment of tax obligations by the foreign contractor; (2) where tax registration or temporary tax registration has not been completed, and an agent in China has not been appointed to fulfill tax obligations on behalf of the foreign contractor; or (3) where the annual or quarterly CIT return has not been filed within the prescribed time limits. In those situations, the tax authority in charge at county level should designate the withholding agent, and at the same time notify the withholding agent of the calculation basis, the

[23] Article 15 of Guo Shui Fa [2009] No. 3.

[24] Article 1 of the Notice on Strengthening Administration of Withholding Tax on Interest Income Derived by Non-resident Enterprises from China, Guo Shui Han [2008] No. 955, issued by the SAT on November 24, 2008.

[25] Article 2 of Guo Shui Han [2008] No. 955.

[26] Article 38 of the CIT Law.

calculation methods, the withholding deadline and the withholding methods.[27] The designated withholding obligator shall, within the declaration term, submit the form of report on CIT withholding and other relevant documents.[28]

Where the withholding agent fails or is unable to withhold CIT, the non-resident enterprise should file a tax return and pay CIT by itself at the place of the project. Within 15 days of confirmation that the CIT has not been withheld, the tax authority should notify the non-resident to file and pay tax at the project location.[29] If the non-resident enterprise fails to pay tax within the deadline specified by the tax authority, the tax authority in charge of the project location shall, within 15 days, collect the information relevant to other income of the non-resident enterprise in China. This information includes types of income, names and addresses of payers, amounts, methods, and dates of payments. The tax authority will issue the Notification of Recovering Overdue Tax of Non-resident Enterprises to the payers of other income items, and collect the tax and late payment charge from the other payers. Those items of other income of the non-resident enterprise in China include income derived by the non-resident enterprise from other engineering or service projects in China. Those items also include income derived by the non-resident enterprise from China but not effectively connected with an establishment or place of business of the non-resident enterprise in China, such as interest, dividends, rentals, royalties, and proceeds on transfer of properties to be paid by a payer in China. If there are multiple payers of other income items due to the non-resident enterprise, the tax authority in charge of the project location should determine the collection orders based on factors such as the level of accuracy of information, the amount of other income, and the collection costs.[30] The tax authority in charge of other payers should provide the necessary information and assist the tax authority in charge of the project in the tax recovery.[31]

12.4 Withholding on Payment to Individuals

Resident enterprises and the establishments or places of business of non-resident enterprises in China have obligations to withhold China taxes on payments to individuals. Such taxes withheld include Individual Income Tax on salaries, wages, bonuses, and other employment compensation and benefits paid to employees, service fees paid to individual independent contractors, and other income such as royalties, dividends, interest, rental,

[27] Article 106 of the CIT Implementation Rules.

[28] Article 15 of SAT Oder [2009] No. 19.

[29] Article 16 of SAT Oder [2009] No. 19.

[30] Article 17 of SAT Oder [2009] No. 19.

[31] Article 18 of SAT Oder [2009] No. 19.

gains on property transfer and causal income paid to individuals.[32] Such taxes withheld also include Business Tax on service fees paid to non-resident individuals.[33]

12.5 Penalties on Withholding Agent

If a withholding agent fails to perform the registration for tax withholding, the tax authorities should request that the correction be made by the withholding agent within three days, and may impose a fine of RMB2,000 or less.[34] If the withholding agent fails to make the correction, the tax authorities may impose a penalty up to RMB10,000.[35] If a withholding agent fails to file the required tax withholding report and other materials, the tax authorities should request a correction within the specified time and may impose a fine up to RMB10,000.[36] If a withholding agent fails to withhold the amount of tax as required in accordance with tax law and regulations, the tax authorities should seek to recover the unpaid tax from the taxpayer and may impose a penalty on the withholding agent in the amount of 50 percent to 300 percent of unpaid tax.[37]

12.6 Enforcement in Conjunction with Foreign Exchange Regulations

Chinese currency is not freely convertible. The conversion of RMB into foreign currencies and the remittance of foreign currencies are subject to foreign exchange regulations. When a payer makes any payment (dividends, interest, rentals, royalties, proceeds for equity transfer, and service fees) in foreign exchanges to a non-resident enterprise, the payer in China can make the payment out of its own foreign currency fund or it can buy foreign currency and then make the payment. The conversion of RMB into foreign currency and or remitting the foreign currency to the non-resident enterprise should be made at one of the banks or other financial institutions that are licensed to conduct foreign exchange business in China. Many Chinese banks, foreign invested banking enterprises, and China branches of foreign banks are licensed to conduct this business. Under the foreign exchange regulations, the financial institutions are required to review certain documents before they can remit the foreign exchanges to receiptants outside China for Chinese payers. On and after January 1, 2009, a payer must show the bank a Tax Certificate for Foreign Exchange

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[32] Articles 2 and 8 of Individual Income Tax Law.

[33] Article 11 of Provisional Regulations on Business Tax.

[34] Article 22 of Guo Shui Fa [2009] No. 3; Article 45 of the Measures for Administration of Tax Registration, SAT Order [2003] No. 7, issued by the SAT on December 17, 2003 and effective on February 1, 2004.

[35] Article 22 of Guo Shui Fa [2009] No. 3; Article 42 of SAT Order [2003] No. 7; Article 60 of the Law of Administration of Tax Collection.

[36] Article 23 of Guo Shui Fa [2009] No. 3; Article 62 of the Law of Administration of Tax Collection.

[37] Article 23 of Guo Shui Fa [2009] No. 3; Article 69 of the Law of Administration of Tax Collection.

Payment for Service Transactions, Income, and Transfers of Current Account Items and Some Capital Account Items issued by the tax authorities for foreign currency remittance of any single payment in the amount of more than USD30,000 for various transactions. This tax certificate is required for payment for, among others, service fees, dividends, interest, guarantee fees, rentals, transfers of property, equity transfers, finance leasing, donations, compensation, and tax. The term "service" is broadly defined, including transportation, tourism, communication, construction and installation, engineering projects, insurance services, financial services, computer and information services, IP licensing, sports and culture, entertainment, other commercial services, and governmental services.[38]

When applying for the tax certificate, the payer within China must submit an application form together with the following materials: (1) written documents evidencing the rights and obligations of parties of a transaction such as a copy of a contract or agreement; (2) a copy of an invoice or other form of request for payment issued by the enterprise outside China; (3) a tax payment certificate or written approval of tax exemption; and (4) other materials that may be requested by the tax authorities.[39] Because of the required item (3), if the payment is taxable, before the payer can apply for the tax certificate, tax must be paid. This means that the payer, as a withholding agent, must withhold and pay the tax first and then can obtain the tax certificate for remittance. If the payment is not subject to tax, the payer must obtain the non-taxable or tax-exemption approval first. Where the non-resident enterprise files a return and pays the tax by itself, the non-resident enterprise should pass the tax payment certificate to the payer so that the payer can obtain the tax certificate.

A tax certificate is not required for any of the following remittance of foreign exchanges:[40]

(1) The remittance of group travel service fees and payments for hotel and transportation by a travel agent within China for overseas travel arrangements;
(2) The payment for repairs, fuel, and harbor expenses incurred outside China by Chinese entities in the high seas fishing business;
(3) The payment for international air and land transportation;
(4) Insurance premium and compensation;

[38] Articles 1 and 2 of the Notice on Relevant Issues Concerning the Submission of Tax Certificates for Foreign Exchange Payment for Services and Other Items, Hui Fa [2008] No. 64, issued by the State Administration of Foreign Exchange and the SAT on November 25, 2008 and effective on January 1, 2009.

[39] Article 5 of the Measures for Administration of Tax Certificates for Foreign Exchange Payment for Services and Other Items, Guo Shui Fa [2008] No. 122, issued by the SAT on December 18, 2008 and effective on January 1, 2009.

[40] Article 1 of the Notice on Further Clarification of the Submission of Tax Certificate for Remittance in Foreign Exchanges for Services and Other Projects, Hui Fa [2009] No. 52, issued by the State Administration of Foreign Exchange and the SAT on November 6, 2009 and effective on November 6, 2009.

(5) The remittance for overseas engineering projects undertaken by entities within China;
(6) Income received by Asia Development Bank and International Finance Corporation under World Bank Group, including dividends received from joint venture companies, gain on equity transfer, income from leasing or transferring properties including real estate in China, and interest on loans to organizations in China;
(7) Interest on loans or sub-lending from foreign governments and international finance organizations (International Monetary Fund, World Bank Group, International Development Association, International Fund for Agriculture Development, and European Investment Bank);
(8) Interest payments, other than those in (7), made by banks for financing the banks' own business such as overseas borrowing, inter-bank borrowing, and payment and agency payment abroad;
(9) Donations made by state organizations at the provincial level or above; and
(10) The payments made to overseas entities or individuals by securities companies or securities depository and clearing companies for the dividends, interest, and trading proceeds legally derived by those payees.

When a representative office of a foreign airlines remits air ticket sales proceeds, the representative office can provide the tax exemption document issued by the tax authorities or the agreement between China and the foreign country on reciprocal exemption of international air transportation income, instead of a tax certificate.[41]

A tax certificate is also required in any of the following situations:[42]

(1) A foreign investor of a foreign invested enterprise converts its share of undistributed retained earnings, capital surplus, or earning reserves of the foreign invested enterprise into the registered capital of the foreign invested enterprise or otherwise reinvests them in China;
(2) A foreign investor reinvests in China the assets received as a result of return of capital, liquidation, equity transfer, or reduction of capital, etc.;
(3) An investee company distributes its profits in foreign exchange to a China investment holding company;
(4) A Qualified Foreign Institutional Investor (QFII) remits investment income; and
(5) A foreign investor who legally holds A-shares of a domestic listed company remits proceeds of selling those shares and dividends paid by the listed company.

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[41] Article 3 of Hui Fa [2009] No. 52

[42] Articles 5 and 6 of Hui Fa [2009] No. 52.

13

LIQUIDATION

13.1 Definition

Liquidation is the process by which a company ceases business operations, settles all its liabilities, distributes remaining assets to its shareholders, and is dissolved.[1] Tax liquidation applies to three situations:

(1) A company is liquidated in accordance with the Company Law. When a company completes its term of operations as provided by its Articles of Association or other situations occur that require liquidation in accordance with the Articles of Association, the company must be dissolved and liquidated in accordance with the Company Law. Shareholders of a company may also determine to liquidate the company under the Company Law. The Company Law also requires that a company be liquidated if the company's business license is withdrawn or cancelled.[2] The laws and regulations concerning Chinese-foreign

[1] Article 1 Cai Shui [2009] No. 60.

[2] Article 181 of the Company Law.

equity ventures,[3] Chinese-foreign cooperative joint ventures,[4] and wholly foreign owned enterprises provide similar situations where the foreign invested enterprises are required to be liquidated.[5] On and after January 15, 2008, liquidation procedures as provided in the Company Law also apply to foreign invested enterprises.[6]

(2) A company is liquidated in accordance with Enterprise Bankruptcy Law. According to Enterprise Bankruptcy Law, a debtor or creditors may apply for bankruptcy for an insolvent debtor company. The bankruptcy proceedings may result in reorganization, reconciliation settlement, or liquidation.[7] In the case of bankruptcy liquidation, bankruptcy of debtor will be declared by the People's Court, and tax liquidation will start after such date of declared bankruptcy. The completion of bankruptcy proceeding shall be approved by the court after completion of liquidation distribution.[8] As tax payment of debtor in bankruptcy has liquidation distribution priority over claims of general creditors, tax liquidation generally would be completed before the completion of bankruptcy proceedings.

[3] Article 90 of the Detailed Rules for the Implementation of Law of Sino-foreign Equity Joint Ventures provides that a joint venture may be dissolved if (1) the joint venture term expires; (2) the joint venture incurs serious losses, rendering it unable to continue operation; (3) a party to the joint venture fails to perform its obligations under the joint venture agreement, contract and/or articles of association, making it impossible for the joint venture to continue operation; (4) the joint venture cannot continue operation due to heavy losses caused by an event of force majeure such as natural calamity, war, etc.; (5) the joint venture fails to achieve its business objectives, with no prospects for its development; or (6) any other cause for dissolution of the joint venture under the joint venture contract and articles of association has occurred.

[4] Article 48 of the Detailed Rules for the Implementation of Law of Sino-foreign Cooperative Joint Ventures provides that a cooperative joint venture may be dissolved if (1) the cooperative joint venture term expires; (2) the cooperative joint venture incurs serious losses or suffers serious loss as a result of force majeure, rendering it unable to continue operation; (3) a party to the cooperative joint venture fails to perform its obligations under the cooperative joint venture agreement, contract and/or articles of association, making it impossible for the cooperative joint venture to continue operation; (4) any other cause for dissolution of the cooperative joint venture under the cooperative joint venture contract and articles of association has occurred; or (5) the cooperative joint venture is ordered closed in accordance with law as a result of violation of laws or administrative regulations.

[5] Article 72 of the Detailed Rules for the Implementation of Law of Wholly Foreign Owned Enterprises provides that a wholly foreign owned enterprise shall be terminated if (1) the enterprise completes its term of operations; (2) the foreign investor decides to dissolve the enterprise because of undesirable business operations and serious loss of the enterprise; (3) the enterprise is not able to continue its business due to force majeure such as natural disaster or war; (4) bankruptcy; (5) business license is withdrawn because of violation of China laws and regulations or danger to public interest; or (6) other dissolution events as provided in the Articles of Association of the enterprise occur.

[6] The Decision on Revocation of Certain Administrative Regulations, Order of State Council [2008] No. 516.

[7] Enterprise Bankruptcy Law, passed by the Standing Committee of the NPC on August 27, 2006, issued by Presidential Order No.54, and effective on June 1, 2007.

[8] Article 120 of Enterprise Bankruptcy Law.

(3) A company is treated as liquidated in an enterprise reorganization. In some situations legal liquidation may or may not be required; for tax purposes, however, the events are treated as liquidation. Those events include a conversion of a legal person such as a corporation into a sole proprietorship, partnership, or other non-legal person organization, or a change of place of registration of an enterprise from China to a foreign country or region (including to Hong Kong, Macao, and Taiwan). The company shall be deemed to have been liquidated, with all assets distributed to the owners of the company, and the owners shall be deemed to have set up a new entity by contributing the assets.[9] A taxable merger is another event of deemed tax liquidation. When an enterprise is merged into another enterprise, the merged enterprise is treated to be liquidated.[10] A taxable de-merger will also result in a deemed liquidation where an enterprise transfers all of its assets and liabilities to two or more other enterprises and the transferor enterprise is not a surviving company.[11]

13.2 Tax Year

The liquidation period of an enterprise constitutes a tax year separate from the tax year for continuing operation of the enterprise.[12] The normal tax year for an enterprise is calendar year. When an enterprise commences liquidation, the tax year for continuing operation will end immediately before the commencement date of liquidation. This means that if the commencement date of liquidation is not January 1, the enterprise will have a short tax year for its continuing operations. The enterprise should file its annual CIT return for its last tax year for its continuing operations, the period from January 1 of the year through the date immediately before the commencement date of liquidation. The enterprise should perform reconciliation and settle the annual CIT payment for the short tax year within sixty days of the short year-end.[13] The enterprise should file a separate CIT return for its liquidation period. Such liquidation period starts from the commencement date of liquidation and ends on the date of completion of liquidation, which can be shorter or longer than a calendar year. The enterprise is required to produce separate financial statements for the last period of continuing operations and the liquidation period.

[9] Article 4(1) of Cai Shui [2009] No. 59.

[10] Article 4(4)(2) of Cai Shui [2009] No. 59.

[11] Article 4(5)(4) of Cai Shui [2009] No. 59.

[12] Article 4 of Cai Shui [2009] No. 60.

[13] Article 55 of the CIT Law.

13.3 Treatment to Liquidating Company

First, the liquidating enterprise must determine gain or loss on all of its assets. If an asset is sold in the liquidation, the gain or loss of the asset should be computed based on the actual transaction price less the tax basis of the enterprise in the asset. If a non-cash asset is transferred to settle a liability or to be transferred to a shareholder, the asset is treated as sold at realizable value and the gain or loss should be determined based on the "cashable price" for the asset less the tax basis of the enterprise in the asset.[14]

Secondly, the liquidating enterprise must determine gain or loss on settlement of its receivables and liabilities.[15] The receivables include loans that the enterprise is owed, account receivables, and all other items where the liquidating enterprise is a creditor. The enterprise generally will not have a gain or loss if it collects full amount of receivables. If the enterprise cannot collect the full amount of a receivable item, the enterprise will realize a loss. However, in order to recognize such loss for CIT purpose, the claim must satisfy the requirements for loss deduction. Please see the requirements for deduction of asset loss in Chapter 5.17. If the requirements cannot be met, the non-deductible amount will become a permanent book and tax difference. If the liquidating enterprise receives a non-cash asset for settlement of a receivable item, the non-cash asset should be priced at either an actual transaction price (i.e., sold subsequent to receiving the asset) or cashable price (where the asset is used to settle a debt or will be distributed to shareholder).

Thirdly, the liquidating enterprise should make adjustments with respect to provisions, deferred expenses, and other similar items.[16] The enterprise may have made certain book provisions such as a provision for bad debt, a provision for inventory obsolete, and a provision for investment loss. Those provisions generally are not deductible for CIT purposes during the period of continuing operations. Now, the enterprise changes its status from continuing operations to liquidation, those items should generally become deductible at liquidation. Another way to look at those items is the difference between net book value and tax basis of an asset or liability. The higher or lower tax basis will be used in determining gain or loss on disposal of asset or settlement of liability. The liquidating enterprise may not be able to deduct all of the provisions at the liquidation. For example, if uncollectible receivables cannot meet the requirements for CIT deduction, the tax authority may disallow a deduction for the gross amount of receivables. In such case, the provision is effectively not recovered by the enterprise. If the enterprise has some deferred expenses that are amortized for CIT purposes, the full remaining balance of such items should become deductible at liquidation.

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[14] Article 3(1) of Cai Shui [2009] No. 60.

[15] Article 3(2) of Cai Shui [2009] No. 60.

[16] Article 3(3) of Cai Shui [2009] No. 60.

Finally, in computing taxable income for the liquidation period, all the allowable current period expenses as well as unexpired losses generated in prior years can be deducted.[17] Liquidation may result in a short and/or long tax year. The use of net operating loss carryovers will be subject to such short or long tax years. The following example illustrates the issue:

Tax period	Net operating loss (RMB)
January 1 - December 31, Year 1	100,000
January 1 - December 31, Year 2	120,000
January 1 - December 31, Year 3	200,000
January 1 - December 31, Year 4	200,000
January 1 - December 31, Year 5	200,000
January 1 - June 30, Year 6	80,000
Accumulated loss prior to liquidation	900,000

Suppose the liquidation lasts 6 months, starting on July 1, Year 6, and ending on December 31, Year 6. The question is whether

RMB100,000 of loss generated in Year 1 can be used to offset gains on liquidation. Tax loss can be carried over for five years. The tax year for enterprises is the calendar year. If the enterprise were not liquidated, the RMB100,000 of loss generated in Year 1 would expire on January 1, Year 7. Because of liquidation, the enterprise has two short years in Year 6; one is the last tax year for operations from January 1 to June 30, Year 6; another is the tax year for liquidation from July 1 to December 31 Year 6. As such, the five-year carryover period should end on June 30, Year 6, and the RMB100,000 of loss generated in Year 1 should not be available to offset any gain on liquidation even though the liquidation year ends within five calendar year periods from the end of Year 1. The RMB120,000 of loss generated in Year 2 can be used to offset gains on liquidation. This is true even if the liquidation year is longer than a calendar year. Suppose the liquidation lasts two years, starting on July 1, Year 6 and ending on June 30 Year 8. As the two-year liquidation period is one tax year, the loss generated in Year 2 should be allowed to carry over into the long tax year.

At the end of liquidation period, the liquidating enterprise should file its final CIT return, Corporate Income Tax Return for Liquidation. If an enterprise had been granted tax incentives such as a reduced tax rate, the reduced rate may not be applicable for the gains on liquidation if the tax incentives are based on specific business revenue.

[17] Article 3(4) of Cai Shui [2009] No. 60.

Furthermore, the liquidation of an enterprise may trigger a claw-back of some tax incentives. For example, one of the conditions for tax holidays for foreign invested manufacturing enterprises granted prior to January 1, 2008 is the enterprises must operate for ten years or more. If an enterprise that enjoyed such holidays is liquidated within the ten-year period, the enterprise must repay the CIT that was previously exempted.

13.4 Treatment to Shareholders

Liquidation distribution to shareholders will be treated as dividends to the extent that the liquidating enterprise has accumulated retained earnings and earning reserves.[18] Whether a shareholder is taxed on the dividend distribution depends on the type of shareholder.

A resident enterprise shareholder generally should be exempted from CIT on this portion of liquidation proceeds/assets received, as dividends between resident enterprises are exempt from CIT on and after January 1, 2008. A non-resident enterprise shareholder should be subject to CIT at 10 percent of this portion of gross distribution of the dividend-equivalent subject to a reduced rate under applicable tax treaty. Resident individual shareholders should be subject to 20 percent Individual Income Tax on this distribution. Non-resident individuals should also be subject to a 20 percent Individual Income Tax; the tax rate, however, can be reduced according to applicable tax treaties. However, if the liquidating enterprise is a foreign invested enterprise, non-resident individual shareholders should be exempt from Individual Income Tax on the distribution of dividend-equivalent.

If the retained earnings and/or earning reserves include profits generated from periods prior to January 1, 2008, the distribution of this portion of liquidation proceeds by a foreign invested enterprise to a foreign investor is exempt from CIT.[19] It is not clear whether a resident enterprise would be subject to CIT on this portion of distribution. An argument can be made that as CIT Law exempts dividends paid between resident enterprises and no tax circular addresses separate treatment of the share of pre-2008 profits of resident enterprise shareholders, such exemption on inter-resident enterprise dividend should apply to dividends paid out of pre-2008 profits. A counter-argument may be made that the distribution of pre-2008 profits should be subject to old tax law and regulations applicable prior to January 1, 2008. Under the old tax regime, if a resident enterprise shareholder is a foreign invested enterprise, the dividends received would be exempt from FEIT; if a resident enterprise shareholder is a domestic company, the domestic company would be subject to tax at a rate difference (i.e., if the domestic company

[18] Article 5 of Cai Shui [2009] No. 60.

[19] Article 4 of Cai Shui [2008] No. 1.

shareholder's tax rate is higher than the dividend paying company's tax rate) provided, however, that the domestic company shareholder would not need to pay tax on the dividends if the tax exemption or lower rate enjoyed by the dividend paying company is result of a fixed term tax incentives.

After the allocation of liquidation distribution to the dividend equivalent, a shareholder is allowed to recover its tax basis or investment cost in its investment in the liquidating enterprise. The difference between the amount of distribution net of dividend-equivalent and the investment cost of a shareholder is the gain or loss on transfer of investment.[20] The investment cost or the tax basis of a non-resident shareholder in the equity of a resident enterprise is the actual capital contribution made to the non-resident enterprise or the consideration actually paid to the seller of equity in the resident enterprise.[21] The same definition of investment cost should also apply to resident enterprise shareholders of a resident enterprise. Accordingly, if a shareholder made an investment in the liquidating enterprise, the investment cost should be the shareholder's share of capital contribution. This generally is the amount of registered capital and capital surplus actually contributed to the liquidating enterprise by the shareholder. Such capital contributions are required to be verified by a CPA firm in the form of a capital verification report which will be required for registration of the capital contributions with the government registration office, the State Administration for Industry and Commerce or its local offices. However, capital surplus account of a liquidating enterprise may include other items. For example, if a shareholder makes a "donation" to an enterprise, the amount of donation is treated as income for CIT purpose; this amount, however, is recorded as "capital surplus" according to the PRC Enterprise Accounting Standards. Similarly, debt forgiveness made by a shareholder is also recognized as income for CIT purposes and recorded as a capital surplus for accounting purpose. It is not clear under the CIT Law and regulations whether this type of capital surplus gives the shareholder tax basis in its investment in the enterprise. In practice, the tax authorities in many locations do not recognize this type of capital surplus as part of the tax basis in investment and do not allow the deduction of this amount in computing gain or loss in a transfer of equity. As such, the tax authorities most likely will take the same approach to a liquidation distribution.

If the equity interest of a shareholder in a liquidating enterprise was originally acquired from another person, the price paid for the equity interest should be the amount of investment cost or tax basis that can be deducted in computing gain or loss on liquidation distribution. For wholly foreign owned enterprises, Chinese-foreign equity joint ventures, and Chinese-foreign cooperative joint ventures, the transfer of equity must be applied by the foreign investment regulator, the Ministry of Commerce, or its local office,

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[20] Article 5 of Cai Shui [2009] No. 60.

[21] Article 3 of Guo Shui Han [2009] No. 698.

and registered with the State Administration for Industry and Commerce or its local office. The equity transfer agreement should be provided to the government. The transfer price as provided in the equity transfer agreement generally will be considered evidence of the investment cost. Generally speaking, the tax authorities do not recognize costs other than the consideration paid for the equity transfer, such as professional fees in connection with the acquisition, as investment cost.

If non-cash assets are distributed or deemed to be distributed in a liquidation, the amount of distribution should be based on the fair market value of assets. The tax treatment of dividend-equivalent, tax basis recovery, and gain or loss on transfer applies to non-cash asset distribution.

13.5 Tax Withholding on Liquidation

Where a shareholder is a non-resident enterprise, a non-resident individual, or a resident individual, the liquidating enterprise generally has the obligation to withhold income tax, if any, from the liquidation distribution. Such withholding obligations are required by different tax laws and regulations.

As a payer, a liquidating enterprise is required under the CIT law to withhold CIT on dividends and gains on property transfer derived by non-resident enterprises on a liquidation distribution.[22] The question is whether the liquidating enterprise has the withholding obligation on a distribution of non-cash assets. It appears that such a withholding obligation exists for non-cash distribution as the payment includes non-monetary payments.[23] In an event of tax liquidation as a result of change of certain entity form or merger, there is no actual distribution of assets. In such situation, a distribution of securities such as the shares of surviving enterprise in a merger can be treated as a payment where a withholding of tax is required. In practice, it is not common to distribute non-cash assets to a non-resident enterprise in a liquidation. It is foreseeable that a surviving enterprise can issue its shares to a non-resident enterprise shareholder of a merged enterprise in a taxable merger. For non-listed companies, shares of a company are recorded under the names of shareholders at company registration authorities. The registration of equity interest in a company is an evidence of ownership of a shareholder regardless of whether share certificate is actually issued or not. In fact, non-list companies including wholly foreign owned enterprises, Chinese-foreign joint ventures, and Chinese-foreign cooperative joint ventures usually do not issue share certificates to investors. It is not practical that the change of registration as a result of the merger will be held off until the completion of tax payment, if any, by non-resident enterprise shareholders. As such,

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[22] Article 37 of the CIT Law; Article 104 of the CIT Implementation Rules.

[23] Article 105 of the CIT Implementation Rules.

in a deemed liquidation as a result of a taxable merger, the merged enterprise or surviving enterprise will not be able to actually withhold CIT. In such a situation, the non-resident enterprise shareholder should report and pay tax, if any, within seven days after the deemed liquidation.[24]

As a payer, a liquidation enterprise is also a withholding agent for liquidation payments to individuals.[25] Similar to the provisions governing payment to non-resident enterprises, an Individual Income Tax withholding agent is required to withhold Individual Income Tax on payments for dividends and property transfer. Such payment includes payment in kind.[26] Similar to a deemed liquidation distribution to a non-resident enterprise in a taxable merger, it would be impractical for the merged enterprise or surviving enterprise to withhold Individual Income Tax on the deemed distribution to individual shareholders. Individual shareholders, including resident and non-resident individuals, should pay Individual Income Tax, if any, on the deemed liquidation by themselves.[27]

A liquidating enterprise should not have the obligation to withhold tax on distributions to a resident enterprise shareholder. The resident enterprise shareholder should report and pay CIT, if any, on the liquidation distribution.

13.6 Liquidation of Company Whose Shares are Traded on Stock Exchanges

There is no different in CIT treatment of liquidation for listed enterprises and non-listed enterprises. The main difference is at the shareholder level. First of all, non-resident individuals are temporarily exempted from dividends paid on B-shares and overseas shares of resident enterprises. The temporary tax exemption originally covered dividends paid to foreign enterprises and foreign individuals by domestic company on B-shares and overseas shares.[28] The tax exemption on dividends derived by foreign enterprises is no longer valid on and after January 1, 2008.[29] However, no tax circular has been issued invalidating the Individual Income Tax treatment of dividends on B-shares and overseas shares. As such, a liquidating enterprise should not be required to withhold Individual Income Tax on the dividend-equivalent portion of liquidation distribution with respect to B-shares and overseas shares held by non-resident individuals. Secondly, individuals

[24] Article 15 of Guo Shui Fa [2009] No. 3.

[25] Article 8 of Individual Income Tax Law.

[26] Article 35 of the Implementation Rules for Individual Income Tax Law.

[27] Article 36(4) of the Implementation Rules for Individual Income Tax Law.

[28] The Notice on the Issues Concerning Income Tax on Gains on Transfer of Shares and Dividends Derived by Foreign Invested Enterprise, Foreign Enterprises, and Foreign Individuals, Guo Shui Fa [1993] No. 45, issued by the SAT on July 21, 1993.

[29] Article 3 of the CIT Law; Guo Shui Han [2008] No. 897; Guo Shui Han [2009] No. 394.

are temporarily exempted from Individual Income Tax on the transfer of shares of listed Chinese companies.[30] It is not clear whether such exemption applies to liquidation of a listed company. In the absence of contrary authorities, however, the tax exemption should apply to the gain on liquidation distribution by a listed company as a portion in excess of tax basis is treated as gain on transfer of shares. Thirdly, it may be difficult for the liquidating enterprise to determine the amount of CIT withheld on gain on liquidation distribution to a non-resident enterprise shareholder, as the liquidating enterprise may not know the investment costs of the shareholder (e.g., the non-resident shareholder bought shares at the stock exchange). If the investment is made through a domestic brokerage account, the brokerage firm should be the withholding agent, as the firm is actually the person who pays non-resident enterprises. Furthermore, the brokerage firm should have better information of the investment cost of the non-resident enterprise shareholder than the liquidating enterprise.

[30] The Notice on Continuing Temporary Exemption from Individual Income Tax on Income on Transfer of Shares, Cai Shui Zi [1998] No. 61, issued by the MOF and the SAT on March 30, 1998.

14

TAX FILINGS AND PAYMENTS

14.1 Tax Bureaus

Since 1994, China has had two tax collection systems, namely, the State tax bureau system and the local tax bureau system. Figure 14.1–1 illustrates the different levels of tax bureaus in a simplified manner. In practice, variation exists in different locations.

Within the State tax bureau system, "vertical reporting" is adopted; each State tax bureau is directly responsible for the tax bureau at above level. The director and deputy directors of a State tax bureau are appointed by the State tax bureau at next level above. Dual leadership is implemented for the local tax bureau system. The local tax bureaus of provinces, municipalities, and autonomous regions not only report to the SAT but also report to the People's Government at their respective provinces, municipalities, and autonomous regions. The director and deputy directors of a local tax bureau at the provincial level are appointed by the People's Government of the province, municipality, or autonomous region at the local tax bureau's location upon the consent of the SAT.[1] This dual leadership system also applies to the lower levels of local tax bureaus.

The tax collection and administration for which each tax bureau is in charge is mainly based on the types of tax. The table below summarizes the collection authority of each tax bureau system:

[1] Guo Ban Fa [1993] No. 87.

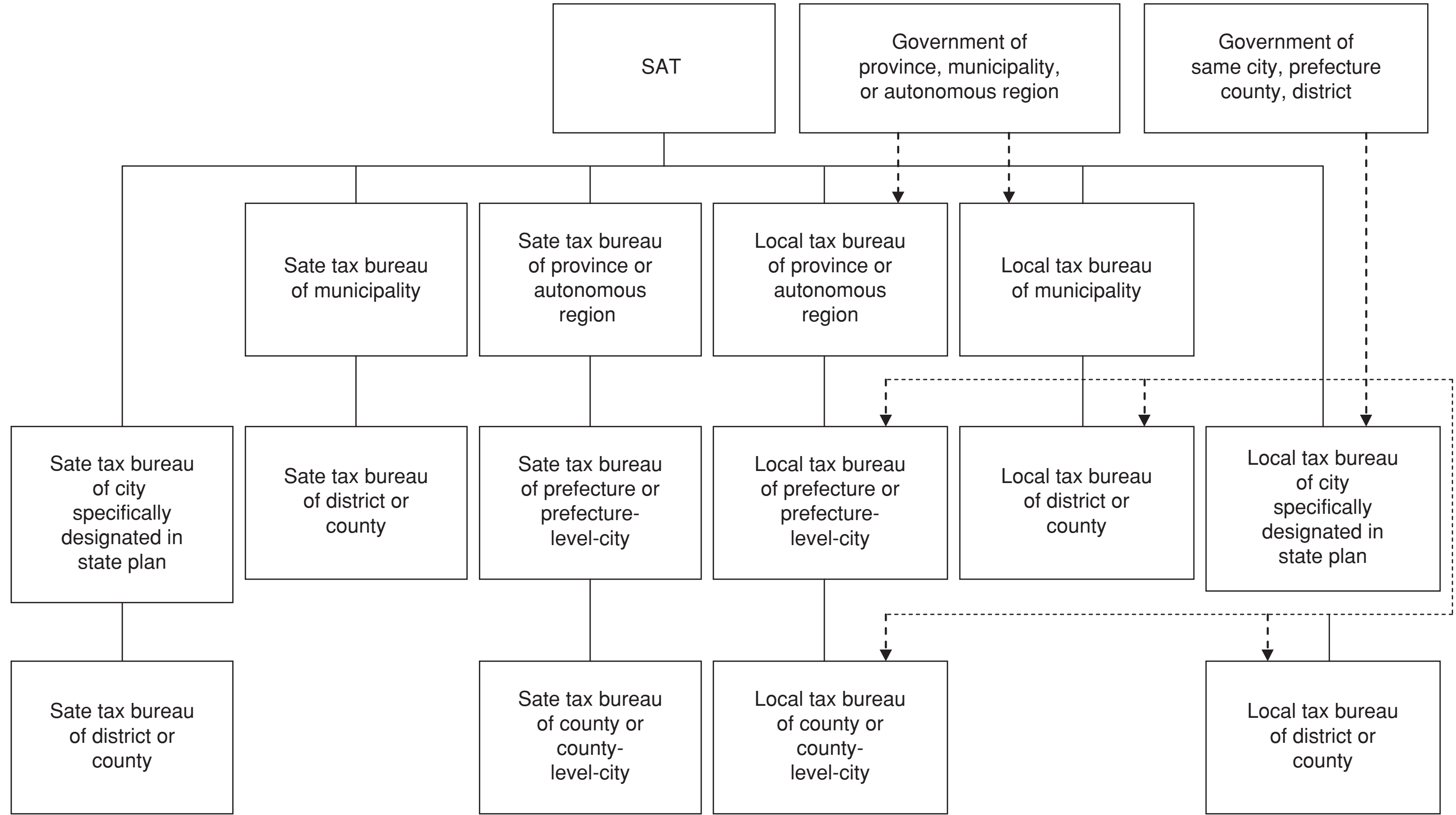

FIGURE 14.1-1 China State and Local Tax Bureaus

Major Taxes	State Tax Bureau	Local Tax Bureau
Corporate Income Tax	√	√
VAT, Consumption Tax	√	
Business Tax	√	√
City Maintenance and Construction Tax, Education Surcharge	√	√
Individual Income Tax, Land Appreciation Tax, Property Tax, Urban Land Use Tax, Stamp Duty, Deed Tax, Vehicle and Ship Use Tax, Resources Tax, Arable Land Use Tax		√

As you may note, both the State tax bureau and the local tax bureau have authority to collect CIT, Business Tax, City Maintenance and Construction Tax, and Education Surcharge. Business Tax is generally collected by the local tax bureau except for certain industries or enterprises such as the railway and the headquarters of certain banks and insurance companies. City Maintenance and Construction Tax and Education Surcharge are taxes computed based on VAT, Consumption Tax, and Business Tax. Those taxes are collected together with VAT, Consumption Tax, and Business Tax collection. As such, if an enterprise pays VAT or Consumption Tax, it will pay City Maintenance and Construction Tax and Education Surcharge to the State tax bureau. If an enterprise pays Business Tax to a local tax bureau, it will pay City Maintenance and Construction Tax and Education Surcharge to the local tax bureau; if an enterprise pays Business Tax to a State tax bureau, it will pay City Maintenance and Construction Tax and Education Surcharge to the State tax bureau.

The assignment of authorization of CIT collection and administration between the State tax bureau and the local tax bureau is more complex. When the State tax bureau and local tax bureau systems were separated in 1994, the State tax bureaus were authorized to be in charge of collection and administration of CIT for the enterprises owned by the central government, the banks and non-bank financial institutions owned by local government and foreign enterprises, offshore oil enterprises, foreign invested enterprises, and foreign enterprises. The local tax bureaus were authorized to be in charge of collection and administration of CIT for the enterprises owned by local governments, collectively owned enterprises, and privately owned enterprises.[2] In 1996, it was clarified that State tax bureaus are in charge of the cooperative enterprises and the joint stock companies established by the enterprises owned by the central government, local governments, and publicly funded organizations.[3] Further adjustments were made in 2002. The collection

[2] The Opinion on the Implementation of the Establishment of the Local Tax Organizations of the SAT and Local Tax Bureaus, issued by the SAT on December 4, 1993 and forwarded via Guo Ban Fa [1993] 87, by the General Office of State Council on December 9, 1993.

[3] The Opinion on Adjustment to the Scope of Tax Collection and Administration between State Tax Bureaus and Local Tax Bureaus, issued by the SAT on January 22, 1996 and forwarded via Guo Ban Fa [1996] No. 4 by

and administration of CIT for all enterprises established on or after January 1, 2002 and registered with the State Administration for Industry and Commerce and its local offices are assigned to State tax bureaus. However, the authority of tax collection and administration of enterprises established prior to January 1, 2002 remains unchanged. Furthermore, the authority of State tax bureaus to the enterprises established on or after January 1, 2002 does not include (1) a newly established enterprise by merger where the merged enterprises were assigned to a local tax bureau; (2) a newly established spin-off enterprise where the old enterprise was assigned to a local tax bureau; and (3) a newly established enterprise as a result of reform of publicly funded institution into a corporation where the old institution was assigned to a local tax bureau. The authority of State tax bureaus also covers organizations, such as publicly funded institutions, social groups, law firms, hospitals, and schools that are newly established and registered on or after January 1, 2002.[4]

After the CIT Law came into effect, the SAT made further adjustments to the scope of tax collection and administration by State and local tax bureaus upon the approval the State Council.[5] Under the new adjustment, the authority of tax collection and administration of enterprises established prior to January 1, 2009 remains unchanged; the authority to the enterprises established on or after January 1, 2009 is generally assigned to State tax bureaus and local tax bureaus based on whether the taxpayers are VAT payers or Business Tax payers. State tax bureaus are in charge of tax collection and administration of CIT of newly established enterprises that are VAT payers; local tax bureaus are in charge of tax collection and administration of CIT of newly established enterprises that are Business Tax payers. However, this general authority allocation rule is subject to the following exceptions:

(1) State tax bureaus are in charge of tax collection and administration of CIT of newly established enterprises (i) whose CIT in full goes to the central government (i.e., no State and local tax sharing) or (ii) that pay Business Tax to State tax bureaus;
(2) State tax bureaus are in charge of tax collection and administration of CIT of new established enterprises that are banks (credit cooperatives) or insurance companies; local tax bureaus are in charge of all other types of financial enterprises; and

the General Office of State Council on January 24, 1996.

[4] The Notice on the Scope of Tax Collection and Administration after the Reform of Tax Revenue Sharing System, Guo Shui Fa [2002] No. 8, issued by the SAT on January 24, 2002.

[5] The Notice on Adjustment to the Scope of Corporate Income Tax Collection and Administration for New Enterprises, Guo Shui Fa [2008] No. 120, issued by the SAT on December 16, 2008 and effective on January 1, 2009.

(3) State tax bureaus continue to be in charge of tax collection and administration of CIT of foreign invested enterprises and representative offices of foreign enterprises.

A "newly established enterprise" for this purpose is an enterprise that is registered with relevant administration for industry and commerce on or after January 1, 2009. Additionally, the non-cash contribution made by shareholders to the enterprise cannot be more than 25 percent of the total registered capital.[6] If the non-cash capital contribution exceeds this 25 percent threshold, the newly registered enterprise will not be treated as a newly established enterprise and, presumably, the tax bureau in charge of the shareholder that contributes major non-cash assets will be in charge of collection and administration of CIT for the enterprise.

The separation of State and local two tax bureaus was intended to allocate more tax revenue to local governments. In practice, the dual systems have created more of a tax burden in compliance and increased administrative costs. Many people argue for unification of the two tax bureau systems. The SAT requires coordination of the two bureaus and encourages the establishment of a tax collection hall where both the State tax bureau and the local tax bureau are located, to mitigate the administrative costs for taxpayers.

The State tax bureau or local tax bureau in charge of an enterprise usually is a tax bureau at the district and county/city level, i.e., one of the tax bureaus shown in the bottom boxes in Figure 14.1-1. For a large district or city, the tax bureau may have several branches and the collection authority is one of these branches. A tax bureau in a city may set up an international tax branch in charge of foreign enterprises and foreign invested enterprises within the city. After the determination as to whether the CIT collection bureau is a State tax bureau or a local tax bureau, the assignment of a specific tax bureau usually is based on the registered address of the enterprise. Some cities may also assign enterprises to different tax bureaus or different branch bureaus based on industry.

The tax bureau in charge of an enterprise is the office where the enterprise files its CIT returns and makes CIT payments. In many locations, the tax bureau assigns a tax official to work with the enterprise with respect to tax collection and other related matter. In some other locations, no specific official is assigned.

14.2 Tax Registration

An enterprise should perform a tax registration with the tax bureau in charge within thirty days after it obtains its Business License. If an existing enterprise sets up a branch

[6] Guo Shui Fa [2008] No. 120; the Notice on the Criteria for Newly Established Enterprises for Enjoying Corporate Income Tax Incentives, Cai Shui [2006] No. 1, issued by the MOF and the SAT on January 9, 2006.

in a city other than the city in which the enterprise is registered, the branch also needs to perform a tax registration in the branch location. The tax bureau in charge of the enterprise or branch should issue a tax registration certificate within thirty days after the submission of registration application.[7]

For initial tax registration, a newly established enterprise or branch should submit various documents to the tax bureau in charge, including: (1) the business license or other type of certificate of business registration; (2) the evidence for place of registration and business (e.g., lease or ownership certificate); (3) the capital verification report or appraisal report; (4) the certificate of unified organization code; (5) the copies of relevant contract and articles of association; (6) the personal identification document of the legal representative of the enterprise; (7) the tax registration certificate of the head office if the tax registration is for a branch; (8) the approval document if the enterprise is established as a result of enterprise reform; (9) the copies of ownership certificate of buildings owned, land use certificate, and certificates of motor vehicles; (10) certain information of the enterprise, including the description of production facilities and processes and the names, standards, and application areas of oil products produced if the enterprise is a taxpayer of Consumption Tax for gasoline or diesel oil; and (11) the certificate of approval issued by the Ministry of Commerce or its local office if the enterprise is a foreign invested enterprise.[8]

Certain taxpayers should apply for temporary tax registration. These taxpayers include (1) a taxpayer that is engaged in production or business operations under a temporary business license; (2) a contractor that leases and operates the business of an owner and makes periodical lease payments to the owner; and (3) a foreign enterprise that undertakes contraction, installment, processing, or exploration projects and provide services. A category (1) taxpayer should apply for the temporary tax registration within thirty days of the issuance of temporary business license. A taxpayer in categories (2) and (3) should apply for the temporary tax registration within thirty days of the signing of relevant contract.

When applying for a temporary tax registration, a taxpayer should submit a tax registration form together with (1) the personal identification document of legal representative (or head) of the taxpayer, (2) the project contract, and (3) a copy of business license or other type of permit. The tax authority in charge should issue a tax registration certificate within twenty working days of the submission of completed application materials.[9]

When the content of tax registration of a taxpayer changes, the taxpayer should update its tax registration within thirty days after the change of its business registration.[10]

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[7] Article 15 of the Law of Administration of Tax Collection.

[8] Operational Guidelines for Taxpayers Concerning Tax-related Matters, issued as appendix to the Notice on the Relevant Issue Concerning Cleaning up, Simplifying, and Combining Tax-related Materials Submitted by Taxpayers, Guo Shui Han [2007] No. 1077, issued by the SAT on November 2, 2007.

[9] Operational Guidelines for Taxpayers Concerning Tax-related Matters.

[10] Article 16 of the Law of Administration of Tax Collection.

If a taxpayer is not required to update its business registration or the change of content of tax registration is irrelevant to business registration, the taxpayer should update its tax registration within thirty days of such change date or the date of approval of the relevant government office or the date of declaration of such change. The application for the change of tax registration should be submitted to the original tax authority. The tax authority should issue a new tax registration certificate within thirty days of submission.[11]

If a taxpayer changes its business address from one district/county to another district/county, such change usually results in a change of the tax authority in charge. In such case, the taxpayer should de-register with the tax authority in charge of the old business location and then register with the tax authority in charge of the new business location. At the tax de-registration with the original tax authority in charge, the original tax authority may review or audit the taxpayer's tax filings before completing the tax de-registration.

When an enterprise is dissolved, files bankruptcy, is canceled, or otherwise ceases its obligation to pay CIT, the enterprise should perform a tax de-registration before it performs its business de-registration with industry and commerce authority or other business registration agency. If a foreign company undertakes a construction, installation, processing, or exploration project and provides services, the foreign company should perform a tax de-registration 15 days before it leaves China upon the completion of the project. During the tax de-registration process, the original tax authority may review or audit the taxpayer's tax filings before completing the tax de-registration.

Similar to an enterprise, a representative office of a foreign enterprise should also perform a tax registration within thirty days after it obtains its Certificate of Business Registration. Furthermore, a representative office is also required to update its tax registration if the context of original tax registration changes. Finally, a representative office must perform a tax de-registration before it completes its business de-registration.

14.3 Provisional Tax Filing and Payment

CIT is computed on an annual basis. The tax year of an enterprise is the calendar year from January 1 to December 31 except the year in which the enterprise is established or terminated where the actual operation during the year is less than 12 months.[12] An enterprise should make monthly or quarterly provisional tax payments during a tax year. The tax authorities determine whether an enterprise makes provisional CIT payments on a monthly or a quarterly basis.[13] Most enterprises file provisional CIT returns and pay provisional CIT on a quarterly basis. An enterprise should file its quarterly (or monthly) provisional CIT return and pay quarterly (or monthly) provisional CIT on or before

[11] Operational Guidelines for Taxpayers Concerning Tax-related Matters.

[12] Article 54 of the CIT Law.

[13] Article 128 of the CIT Implementation Rules.

the 15th day after the end of relevant quarter (month).[14] The provisional CIT payments shall be calculated based upon the actual profits for the quarter (month). Where it is difficult for an enterprise to determine its provisional CIT payments based on the actual profits of the quarter (month), the provisional CIT payments may be determined based on the average quarterly (monthly) profits for the prior year or based on other method permitted by the tax authorities. Once a provisional payment method is determined, that method shall not be arbitrarily changed within the year.[15]

In computing provisional CIT payment for a quarter (month), unexpired tax losses from prior years as well as losses from prior quarters (months) within the same year can be used to offset profit for the quarter (month).

CIT is generally filed on a legal entity basis. Unless otherwise approved by the SAT,[16] consolidated CIT filing for different legal entities within an enterprise group is not permitted. A resident enterprise owning branches should compute its CIT on a consolidated basis including income and expenses of all branches.[17] However, an enterprise with branches may need to file a provisional CIT return and pay provisional CIT at the locations of branches. The main reason for the payment of provisional CIT at branch locations is to balance the interest of provinces, municipalities, and autonomous regions. The CIT revenue collected is shared between the central government and local governments. The current share ratio is 60 percent to the central government and 40 percent to local governments. Prior to January 1, 2008, a foreign invested enterprise filed and paid CIT in the city where its head offices were "located," which is the place of business registration. The combined CIT return included the income from all branches regardless of branch locations. Under that system, the tax bureau at the enterprise's headquarters collected 100 percent of CIT from the enterprise. The local government retained 40 percent of the CIT collected and forwarded the remaining 60 percent to the central government. Cities with normal branches did not receive any CIT revenues from those foreign invested enterprises. For enterprises other than foreign invested enterprises, branches were generally considered taxpayers and filed and paid CIT locally unless otherwise approved by the Ministry of Finance and/or State Administration of Taxation. The government at a branch location would retain 40 percent of CIT collected and forward the remaining 60 percent to the central government. The new CIT Law has adopted in principle the CIT filing method used for foreign invested enterprises under the old CIT system. If all CIT were to be paid to the tax bureaus at the headquarters locations, the tax revenues of many local governments, especially those in the inland

[14] Article 54 of the CIT Law.

[15] Article 128 of the CIT Implementation Rules.

[16] The consolidated group filing is only available for limited stated owned enterprises with special approval of the SAT.

[17] Article 50 of the CIT Law.

provinces, would be reduced, as most corporate headquarters are located in the more developed cities in the coastal areas. In order to solve this revenue shifting problem, the MOF, the SAT, and the People's Bank of China issued Cai Yu [2008] No. 10,[18] which provides the method for allocating CIT payments between central and local governments for taxpayers with headquarters and branches across multiple provinces. To implement Cai Yu [2008] No. 10, the SAT issued Provisional Measures for Collection and Administration of Corporate Income Tax for Enterprises that Have Branches in Multiple Regions and File Consolidated Corporate Income Tax Returns.[19]

This provisional CIT allocation between the headquarters location and branch locations applies to a resident enterprise that has at least one branch with production or business operations legally registered in another province, municipality, autonomous region, or city specifically designated in the State plan. The allocation does not apply to non-resident enterprises. It also does not apply to special industries and those enterprises whose tax revenue is within the scope of normal central-local revenue sharing regime.[20] The CIT revenue of these enterprises goes directly to the central government.

On and after January 1, 2008, when a resident enterprise (other than the excludable enterprises) with cross-province branches files its quarterly (or monthly) provisional CIT return, the enterprise should allocate provisional CIT payment based on the following steps:

The first step is to identify participating branches. Participating branches are the first-tier branches with principle operational functions. The second or lower-tier branches should be consolidated into the first-tier branch for calculation of tax payment allocation. The first-tier branches that undertake no principal operational functions and do not pay business tax or VAT at their locations do not participate in the allocation. Excludable branches include those providing after-sales services, internal R&D, warehousing, and other internal ancillary functions. A new branch should participate in the allocation from the year following the year of establishment. A dissolving branch stops participating the year after it is dissolved.[21] If an enterprise has a separate production or business

[18] Provisional Measures for the Administration of the Allocation and Budget of Corporate Income Tax the Headquarters and Cross-Province Branches, Cai Yu [2008] No. 10, issued by the MOF, the SAT, and the People's Bank of China on January 15, 2008 and effective on January 1, 2008.

[19] Provisional Measures for Collection and Administration of Corporate Income Tax for Enterprises that Have Branches in Multiple Regions and File Consolidated Corporate Income Tax Returns, Guo Shui Fa [2008] No. 28, issued by the SAT on March 10, 2008 and effective on January 1, 2008.

[20] According to Article 2 of Guo Shui Fa [2008] No. 28, those excludable enterprises include such as railway transport enterprises (including Guangzhou Railway Group and Daqin Railway Company), state-owned postal service enterprises, Industrial and Commercial Bank of China Inc., Agricultural Bank of China, Bank of China Inc., China Development Bank, Agricultural Development Bank of China, Export-Import Bank of China, Central Huijin Investment Ltd., China Construction Bank Ltd., China Jianyin Investment Ltd., PetroChina Ltd., China Petroleum and Chemical Ltd., and offshore oil and natural gas enterprises (including Hong Kong, Macao, Taiwanese, foreign, and foreign-invested offshore oil and natural gas enterprises).

[21] Cai Yu [2008] No. 10.

operating division and the business revenue, staff salary, and assets of such division are accounted separately from those of the divisions that exercise management functions, such operating division can be treated as a separate branch for the provisional CIT payment allocation purposes. On the other hand, if the revenue, salary, and assets of the operating division cannot be separated from those of management divisions, the operating division should be treated as part of headquarters and is not treated as a participating branch.[22] The headquarters of an enterprise should submit a list of first-tier branches to the tax bureau at the headquarters location and provide proof of a first-tier branch to the tax bureau at the branch location. Such proof includes certificate of funding provided by the headquarters, the agreements between the branch and the headquarters, the Articles of Association of the enterprise, and management system. If a branch conducts production or business operations under the name of headquarters and cannot provide required proof of the status of a first-tier or lower-tier branch, the branch will be deemed to be an independent taxpayer and pay CIT locally.[23]

The second step is to allocate the total provisional CIT for the quarter (or month) between headquarters and participating branches. During each provisional CIT filing, CIT payable by an enterprise will initially be allocated 50 percent to the headquarters and 50 percent to the participating branches. As such, an enterprise should pay 50 percent of its CIT for the period (quarter or month) to the tax bureau at the headquarters location. Actually the 50 percent of provisional CIT collected by the tax bureau at the headquarters location will be further divided into two parts. Fifty percent (i.e., 25 percent of total provisional CIT payment) will be retained by the local government and the remaining 50 percent will go to the State treasury to be further distributed.[24] As such, if the enterprise has a participating branch or an operating division that is treated as a branch in the headquarters location, the tax bureau at the headquarters location will collect more than 50 percent of total provisional CIT for the quarter (month) because of the allocation of provisional CIT to the branch at the headquarters location.

The third step is to allocate the remaining 50 percent of the total amount of provisional CIT to the participating branches. The 50 percent of provisional CIT is apportioned among those branches based on three factors: gross revenue, payroll, and total assets. CIT paid to the tax bureau at one participating branch location should be equal to the following:

50% of total CIT for the period x (Revenue of the branch ÷ Revenue of all participating branches x 0.35 + Payroll of the branch ÷ Revenue of all participating branches x 0.35 + Assets of the branch ÷ Assets of all participating branches x 0.30)

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[22] Article 10 of Guo Shui Fa [2008] No. 28.

[23] Article 1 of the Notice on Certain Issues Concerning the Collection and Administration of Corporate Income Tax for Enterprises that Have Branches in Multiple Regions and File Consolidated CIT Returns, Guo Shui Han [2009] No. 221, issued by the SAT on April 29, 2009 and effective on January 1, 2009.

[24] Article 19 of Guo Shui Fa [2008] No. 28.

The amounts of revenue, payroll, and assets used in the formula for periods from January to June should be the numbers for the year before the last year; for the periods from July to December, the numbers from the previous year should be used. Once the apportionment percentage is determined, no adjustment will be made during the year.[25] As to the three factors, a branch's revenue is all business revenue such as production and service revenue realized by the branch;[26] a branch's payroll refers to all types of compensation for services of staff and workers of the branch;[27] a branch's total assets refer to all financial resources held or controlled by a branch office which, excepting intangible assets, can be measured in monetary terms.[28] The revenue, payroll, and total assets of branches shall be determined based on the financial accounting reports of the enterprise.[29] The enterprise should pay provisional CIT to the tax bureau at the location of each participating branch according to the apportionment.

Where different tax rates are applicable to headquarters and branches, the enterprise will need to go through income allocation and then CIT allocation. Specific procedures are (1) the enterprise computes the taxable income of the whole enterprise; (2) the enterprise allocates its taxable income to headquarters and each branch using the methods described in step two (50/50 allocation between headquarters and branches) and step three (apportion among branches) above; (3) CIT of headquarters and branches is computed based on the allocated taxable income and the applicable tax rates of headquarters and branches, respectively; (4) the amounts of CIT of headquarters and branches that are separately computed in step (3) are combined as the total provisional CIT of the enterprise for the period; (5) the enterprise goes through step two (50/50 allocation between headquarters and branches) and step three (apportion among branches) to determine the provisional CIT that should be paid to each location of headquarters and branches. Generally speaking, an enterprise should apply the same applicable tax rate to compute its CIT except otherwise provided in the rules concerning tax incentives according to Guo Fa [2007] No. 39, Cai Shui [2008] No. 1, and Cai Shui [2008] No. 21.[30].

If an enterprise did not properly allocate provisional CIT payment in accordance with Guo Shui Fa [2009] No. 28, resulting in more provision CIT was paid to one or more locations and less provisional CIT was paid to other locations, the enterprise should make corrections in the provisional CIT payments for the following period. The enterprise should recompute the correct amount of provisional CIT payable to headquarters and each participating branch, and pay additional provisional CIT to the location where

[25] Article 23 of Guo Shui Fa [2008] No. 28.

[26] Article 24 of Guo Shui Fa [2008] No. 28.

[27] Article 25 of Guo Shui Fa [2008] No. 28.

[28] Article 26 of Guo Shui Fa [2008] No. 28.

[29] Article 27 of Guo Shui Fa [2008] No. 28.

[30] Article 2 of Guo Shui Han [2009] No. 221.

provisional CIT is under paid and deduct such amount in the location where provisional CIT is overpaid.[31]

A non-resident enterprise that has an establishment or place of business in China should file its provisional CIT return and pay CIT at the place where the establishment or place of business is located. If a non-resident enterprise has two or more establishments or place of business in China, it may, upon the approval of the tax authority, select its principal establishment or place of business to pay CIT on a consolidated basis.[32] This consolidated CIT filing typically applies to branches of a foreign bank and offshore oil and gas exploration of a foreign enterprise. This rule of place of tax filing for the establishment or place of business of foreign enterprise applies to both quarterly (monthly) provisional CIT filing and annual CIT filing.

A construction enterprise may have projects in different provinces, municipalities, autonomous regions, and cities specifically designated in the State plan. These projects may be managed directly by the headquarters of the construction enterprise or by branches of the construction enterprise. The SAT issued a circular concerning the implementation of Guo Shui Fa [2008] No. 28 for construction enterprises.[33]

If a construction enterprise has branches outside the province, municipality, autonomous region, or city specifically designated in the State plan where the headquarters of the enterprise are located, and the projects outside the headquarters location are managed by the branches, then the first-tier branches should pay provisional CIT based on the income allocation between headquarters and branches in accordance with Guo Shui Fa [2008] No. 28. Provisional CIT should not be paid locally by the second or lower-tier branches. The revenue, payroll, and assets of second- or lower-tier branches should be consolidated into first-tier branches for computation of provisional CIT payment at the locations of first-tier branches.[34]

If a construction enterprise directly manage a project outside the province, municipality, autonomous region, or city specifically designated in the State plan where the headquarters of the enterprise are located, the enterprise should make monthly or quarterly provisional CIT payments equal to 0.2 percent of business revenue actually derived from the project; and such provisional CIT should be paid by the project unit to the tax bureau at project unit location.[35]

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[31] Article 4 of Guo Shui Han [2009] No. 221.

[32] Article 51 of the CIT Law.

[33] The Notice on the Collection and Administration of Corporate Income Tax for Construction Enterprises Operating in Multiple Regions, Guo Shui Han [2010] No. 156, issued by the SAT on April 19, 2010 and effective on January 1, 2010.

[34] Article 2 of Guo Shui Han [2010] No. 156.

[35] Article 3 of Guo Shui Han [2010] No. 156.

The headquarters of a construction enterprise should compute CIT on a consolidated basis including income of the headquarters and branches; provisional CIT will be paid as follows:[36]

(1) If the enterprise only has project units (i.e., no branches), its headquarters will subtract provisional CIT paid locally by its project units and then pay the reminder of consolidated provisional CIT in the location of the headquarters;
(2) If the enterprise only has first-tier branches (i.e., no outside projects directly managed by the headquarters), it should compute and allocate its provisional CIT in accordance with Guo Shui Fa [2008] No. 28; and
(3) If the enterprise has both first-tier branches and directly managed projects outside its headquarters location, the enterprise should first deduct provisional CIT paid for the directly managed projects and then allocate provisional CIT between the headquarters and branches in accordance with Guo Shui Fa [2008] No. 28.

A construction enterprise that has projects outside its headquarters location should obtain a Certificate of Tax Administration for Business Operations Outside Headquarter Location issued by the tax bureau at the headquarters location. The enterprise should provide the certificate to the tax bureau at the project location. If the enterprise cannot provide such a certificate, the project needs to pay CIT locally as a separate taxpayer. If the project is managed by a first-tier branch of the enterprise, the project unit must also provide the tax bureau at the project location with a document issued by the headquarters to prove that the project is managed by the branch.[37] When the headquarters makes provisional CIT payments at the headquarters location, it should provide the tax bureau at the headquarters location with the receipts of the provisional CIT paid locally for the directly managed projects outside the headquarters location.[38]

The State tax bureau and local tax bureau at a province, a municipality, an autonomous region, or a city specifically designated in the State plan may jointly issue local rules for tax administration of construction enterprises established and operating with the province, municipality, autonomous region, or city specifically designated in the State plan but having projects in other cities or counties within the province, a municipality, an autonomous region, or a city specifically designated in the State plan. Such local rule must be filed with the SAT.[39]

[36] Article 4 of Guo Shui Han [2010] No. 156.
[37] Article 6 of Guo Shui Han [2010] No. 156.
[38] Article 7 of Guo Shui Han [2010] No. 156.
[39] Article 8 of Guo Shui Han [2010] No. 156.

14.4 Annual CIT Filing

An enterprise should file an annual CIT return on or before May 31 of the year following a tax year.[40] If the CIT liability on the annual CIT return is greater than the total amount of provisional CIT payments, the enterprise should pay the balance before the filing deadline. If the CIT liability is less than the total amount of provisional CIT payments, the enterprise can claim a refund of overpayment. This settlement of CIT with annual CIT filing is often called annual CIT reconciliation. Unless otherwise specified by tax law and regulations, a resident enterprise should file its annual CIT return and perform the annual reconciliation at the location of its business registration. However, if a resident enterprise is a company registered outside China, the enterprise should file annual CIT and pay CIT at the place of its effective management.[41] This annual CIT filing at the location of business registration also applies to enterprises that are required to make provisional CIT payments at the locations of branches (see Chapter 14.3 for allocation and payment of provision CIT at branch locations). This means that an enterprise does not need to file its annual CIT return and perform annual CIT reconciliation for branches and it should only pay additional CIT to or file a claim for CIT refund with the tax bureau at its place of business registration (or the place of effective management for a resident enterprise incorporated overseas).

If an enterprise terminates its business operation before the end of a calendar year, it should file its annual CIT return for the last operating period within sixty days of the date of the actual termination of the business operation.[42] A non-resident enterprise that has an establishment or place of business in China should file its annual CIT return and pay CIT at the place where the establishment or place of business is located. Similar to a resident enterprise, the annual CIT return for a non-resident enterprise that has an establishment or place of business in China should file its annual CIT return on or before May 31 following a tax year. If a non-resident enterprise has two or more establishments or place of business in China, it may, upon the approval of the tax authority, select its principal establishment or place of business to pay CIT on a consolidated basis.[43]

In Chapter 14.3, we discussed the special rule for provisional CIT payments for construction enterprises operating projects outside their headquarter locations. Similar to other enterprises, only the headquarters of a construction enterprise is required to perform annual CIT reconciliation at the tax bureau at the headquarters; branches and project units do not need to perform annual CIT reconciliation.[44] When the

[40] Article 54 of the CIT Law.

[41] Article 50 of the CIT Law.

[42] Article 55 of the CIT Law.

[43] Article 51 of the CIT Law.

[44] Article 5 of Guo Shui Han [2010] No. 156.

headquarters of a construction enterprise performs its annual CIT reconciliation at the headquarters location, it should provide the tax bureau at the headquarters location with the receipts of provisional CIT paid locally for the directly managed projects outside the headquarters location.[45]

14.5 Translation of Foreign Currency

Where the income of an enterprise is calculated in a currency other than RMB, the taxable income shall be converted into RMB using the medium exchange rate on the last day of a month or a quarter for which the provisional CIT payments are made. When settling the annual payment after the end of the year, the provisional CIT payments that have been made will not be reconverted; instead, the enterprise should calculate that part of its taxable income for which the provisional CIT payments have not been made, and convert such taxable income into RMB using the medium exchange rate on the last day of the year.[46]

Where a withholding agent makes a payment to a non-resident enterprise in foreign currency, for the purpose of computing CIT, the withholding agent should convert the foreign currency into RMB using the medium exchange rate published by the State on the tax payment date.[47]

14.6 Filing of Withholding Tax

Where a non-resident enterprise derives dividends, interest, rent, royalty, the gain on property transfer, or other income from China, the person who has the direct obligation to pay the non-resident enterprise under the applicable law or contract is a withholding agent.[48] A withholding agent should perform tax withholding registration with the tax authority in charge within 30 days of signing the contract in relation to the income listed above.[49] When a withholding agent makes a payment or the payment is due and payable, the withholding agent should withhold CIT from the payment, file Corporate Income Tax Withholding Return with the tax authority in charge of the withholding agent, and deposit the tax withheld with the Treasury within seven days of the

[45] Article 7 of Guo Shui Han [2010] No. 156.

[46] Article 130 of the CIT Implementation Rules.

[47] Article 9 of the Provisional Administrative Measures for Withholding of Tax at Source for Non-resident Enterprises, Guo Shui Fa [2009] No. 3, issued by the SAT on January 9, 2009 and effective on January 1, 2009.

[48] Article 3 of Guo Shui Fa [2009] No. 3.

[49] Article 4 of Guo Shui Fa [2009] No. 3.

withholding date.[50] The tax authorities should pay withholding agents a withholding handling fee,[51] which is 2 percent of the amount of tax withheld.[52]

Where a non-resident enterprise transfers its equity interest in a resident enterprise to another non-resident enterprise and the transfer occurs outside China, the non-resident enterprise buyer generally is not a withholding agent. The non-resident seller should pay CIT to the tax authority in charge of the resident enterprise whose equity was transferred. Please also see discussions about withholding tax at source in Chapter 12.1.

14.7 Interest and Penalties

14.7.1 LATE PAYMENT CHARGE AND INTEREST

If an enterprise fails to pay or underpays its CIT liability, a late payment charge at a daily rate of 0.05 percent (i.e., an annual rate of 18.25 percent) on the underpayment is imposed.[53] This rate applies to tax due dates on or after May 1, 2001. Late payment charge for tax liability incurred in the period from January 1, 1993 to April 30, 2001 is 0.2 percent per day. The late payment charge should start from the date immediately following the last due date for such tax payments and end on the date that the tax is actually paid.[54] If an enterprise obtains an approval of the tax authorities for an extension of time to file a CIT return, the enterprise should pay, on or before the return original due date, the actual tax paid for the prior period or the amount determined by the tax authorities. If the actual tax payable is greater than the amount paid on or before the original due date, no late payment charge is imposed on the additional tax payment on or before the approved extended filing date, provided the return is properly filed on or before this date.[55]

When the tax authorities make special tax adjustments, including adjustments for transfer pricing, controlled foreign corporation, thin capitalization, and general anti-avoidance, with respect to transactions occurring on or after January 1, 2008, interest will be imposed, on a daily basis, upon the underpaid taxes. The interest rate is the RMB base lending rate published by the People's Bank of China in the year(s) to which the underpaid tax relates for a loan of the same term as the period for which additional tax is payable, plus 5 percent. However, if an enterprise provides contemporaneous documentation and other information in accordance with the tax regulations or is exempted from preparation

[50] Article 7 of Guo Shui Fa [2009] No. 3.

[51] Article 30 of Law of Administration of Tax Collection.

[52] The Notice on Specific Issues Concerning the Provision and Payment of Withholding Handling Fees by Collection Authorities, Cai Yu Zi [1994] No. 217, issued by the Ministry of Finance on July 12, 1994.

[53] Article 32 of the Law of Administration of Tax Collection.

[54] Article 75 of the Implementation Rules for the Law of Administration of Tax Collection.

[55] Reply on the Issues Concerning Late Payment Charge on Provisional Tax Payment For Tax Filing on Extended Date, Guo Shui Han [2007] No. 753, issued by the SAT on July 10, 2007.

of contemporaneous documentation under the Implementation Rules for Special Adjustments, the interest rate or transfer pricing adjustment should be reduced to the base lending rate.[56] Where an interest charge is applicable for special tax adjustment, the 0.05 percent daily late payment charge should not apply. For more discussion on interest charge for transfer pricing adjustment, please see Chapter 11.10.

14.7.2 ADMINISTRATIVE PENALTIES

The Law of Administration of Tax Collection authorizes the tax authorities to impose administrative penalties, in addition to tax and late payment charges or interest, if any, on taxpayers and/or the withholding agent. Basically, there are two types of administrative penalty. One type is a fine for the failure to take required action by a taxpayer or a tax-withholding agent, and such failure to act is not necessarily the result of underpayment of tax. The tax authorities can impose a fine of not more than RMB2,000; in a serious case, a fine of RMB2,000 to RMB10,000 for various events including, et alia, the failure to perform tax registration, change tax registration, or perform tax de-registration by a taxpayer, the failure to set up or maintain accounting books and records by a taxpayer,[57] the failure to file a tax return or other required information by a taxpayer,[58] and the failure to file a withholding tax return or provide required information by a withholding agent.[59] The tax authorities can impose a fine of not more than RMB2,000; in a serious case, a fine of RMB2,000 to RMB5,000 for the failure by a withholding agent to set up or maintain required accounting books and records in relation to tax withheld.[60] Another type of administrative penalty is a fine as a percentage of tax underpaid or underwithheld. If a taxpayer fails to report tax, fails to pay or underpays the tax payable, the tax authorities may impose a fine of 50 percent to 500 percent of underpaid tax.[61] If a withholding agent fails to withhold tax that should have been withheld, the tax authorities may impose on the withholding agent a fine of 50 percent to 300 percent of tax underwithheld, in addition to recovering underpaid tax from the taxpayer.[62]

These tax administrative penalties apply to the filings and payments of all types of tax, including CIT. In practice, the tax authorities have discretionary power to impose administrative penalties. For most tax adjustments, as a result of a normal tax audit, as long as the taxpayer pays the tax and late payment charges, the tax authorities often do not impose the second type of penalty (50 percent to 500 percent of underpaid tax).

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[56] Article 107 of Guo Shui Fa [2009] No. 2.

[57] Article 60 of the Law of Administration of Tax Collection.

[58] Article 62 of the Law of Administration of Tax Collection.

[59] Article 62 of the Law of Administration of Tax Collection.

[60] Article 61 of the Law of Administration of Tax Collection.

[61] Article 64 of the Law of Administration of Tax Collection.

[62] Article 69 of the Law of Administration of Tax Collection.

However, the tax authorities most likely will impose penalties in tax fraud cases that often involve intentionally underreported tax without legal basis or false accounting books and records.

14.7.3 CRIMINAL PENALTIES

In addition to the recovery of tax and the imposition of late payment charge and administrative penalties, a taxpayer and a withholding agent can be prosecuted in a criminal trial for tax evasion. If a taxpayer files false tax returns by cheating or concealment or fails to file tax returns, and the amount of evaded taxes is relatively large and accounts for more than 10 percent of the payable taxes, he shall be sentenced to fixed-term imprisonment of not more than three years, or to criminal detention, and shall be fined. Where the amount of evaded taxes is huge and accounts for more than 30 percent of the payable taxes, the taxpayer shall be sentenced to fixed-term imprisonment of not less than three years but not more than seven years, and be fined. Similarly, if a tax-withholding agent fails to pay or fails to pay in full the withheld or collected taxes by cheating or concealment, and the amount is relatively large, the above criminal penalties will also be imposed on the withholding agent. However, if a taxpayer or a withholding agent who committed the act as described above has made up the payable taxes and paid the late payment charge upon the notice of tax authorities for tax recovery according to law, and has received the administrative penalty, the taxpayer or withholding agent should be released from criminal prosecution. However, such relief is not available to a person who has been criminally punished for tax evasion or has been, twice or more, administratively punished by the tax authorities within five years.[63] Where a taxpayer or a withholding agent is an enterprise in a criminal case, the enterprise will be fined and the imprisonment and criminal detention discussed above will apply to the persons directly in charge and other persons held directly responsible for the acts.[64] "The persons directly in charge and other persons held directly responsible" are not defined in the Criminal Law. According to the discussions at a meeting of courts on trials of financial crime cases that were endorsed by the Supreme Court of the PRC, "the persons directly in charge" are those who play a role of decision making, approval, connivance, or direction in a crime committed by an organization. Generally speaking, those are principal supervisors, including legal representative of a company. The phrase "other persons held directly responsible" refers to those who specifically implement a crime and play a relatively important role in the action. Those can be management personnel and can also be staff of the company or other persons engaged. A person who participates in implementation of a crime committed by a company under instructions of his or her leader is generally not subject to criminal

[63] Article 201 of Criminal Law.

[64] Article 211 of Criminal Law.

liability.[65] In practice, there are no detailed and uniformed standards, such as certain positions at enterprises, regarding "the persons directly in charge and other persons held directly responsible." The courts will make a determination based on specific facts.

14.8 Statute of Limitation

The statute of limitation on the recovery of tax, late payment charge, and administrative penalties by the tax authorities are provided in the Law of Administration of Tax Collection. The authorities are authorized to seek the recovery tax and late payment charge within three years for underpayment of tax or under-withholding other than transfer pricing adjustment, tax evasion, tax fraud, and the refusal of tax payment. If the amount of tax in aggregate underpaid or under-withheld is RMB100,000 or more, the statute of limitation is extended to five years.[66] The application of the three-year or five-year rule seems very limited under the Law of Administration of Tax Collection. The law provides that such limitation only apply where the underpayment of tax is due to the mistakes, such as computation errors, of a taxpayer or a withholding agent. The recovery of tax and imposing late payment charges for tax evasion, tax fraud, and the refusal of paying tax by a tax payer or withholding agent are not subject to this limitation.[67] The regulations under the Law of Administration of Tax Collection narrowly defines the mistakes referred to in the law as unintentional computation errors and obvious typos.[68] In practice, however, the tax authorities usually do not go beyond the five-year period unless the situation is tax fraud. Although there is no specific definition of tax evasion and tax fraud, the SAT views that failure to file a tax return is not considered as tax evasion or tax fraud and therefore the statute of limitation of three- and five-year periods is applicable.[69] The above permitted tax recovery periods start from the date that a taxpayer should have paid tax or a withholding agent should have withheld and paid tax.[70] The statute of limitation for transfer pricing adjustments is 10 years.[71]

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[65] The Minutes of Courts of Nation-wide on the Discussions on the Trials of Financial Crime Cases, Issued by the Supreme Court by Nation-wide Courts, Fa [2001] No. 8, issued by the Supreme Court of the PRC on January 21, 2001.

[66] Article 82 of the Implementation Rules for the Law of Administration of Tax Collection.

[67] Article 52 of the Law of Administration of Tax Collection.

[68] Article 81 of the Implementation Rules for the Law of Administration of Tax Collection.

[69] Reply on the Issue of Time Limitation for Recovery of Tax Due to Failure to File Tax Returns, Guo Shui Han [2009] No. 326, issued by the SAT on June 15, 2009.

[70] Article 83 of the Implementation Rules for the Law of Administration of Tax Collection.

[71] Article 123 of the CIT Implementation Rules.

The statute of limitation for administrative penalties is five years. If an act in violation of tax law and regulations is not discovered within five years, the tax authorities cannot impose administrative penalties on a taxpayer or a withholding agent for such act.[72]

14.9 Confidentiality of Tax Information

Taxpayers and withholding agents have the right to request the tax authorities and the tax authorities have the obligation to keep the information of taxpayers and withholding agents confidential.[73] If the tax authorities breach this obligation, the persons directly in charge and other persons held directly responsible for within the tax authorities should be subject to administrative punishment.[74] The confidential information is the commercial secrecy and private information of taxpayers that is prepared or collected in tax administration and collection, mainly including the information about the technology and business of a taxpayer and its principal investors as well as the personal matters that a business operator does not want to disclose.[75] The tax authorities and their personnel may not disclose the confidential information to offices outside the authorities, public, or individuals except when (1) disclosing information in accordance with law and regulations, (2) disclosing information to a third party who requests the information in accordance with law, (3) releasing information to the taxpayer itself, and (4) disclosing information upon the consent of the taxpayer.[76]

The information about the actions of taxpayers and withholding agents in violation of tax law is not within the scope of confidential information.[77] The tax authorities may publish the information about a taxpayer if the taxpayer fails to pay tax within the time limit, including approved extension, after filing a tax return or a tax assessment made by the tax authority.[78] In the case of an enterprise taxpayer, the information can include the name of the enterprise, the identification number of the taxpayer, the name and personal identification number of the legal representative or responsible person, the business place,

[72] Article 86 of the Law of Administration of Tax Collection.

[73] Article 8 of the Law of Administration of Tax Collection.

[74] Article 87 of the Law of Administration of Tax Collection.

[75] Article 5 of the Implementation Rules for the Law of Administration of Tax Collection; Article 2 of Provisional Measures for the Administration of Confidential Information of Taxpayers, Guo Shui Fa [2008] No. 93, issued by the SAT on October 9, 2008 and effective on January 1, 2009.

[76] Article 3 of Guo Shui Fa [2008] No. 93.

[77] Article 5 of the Implementation Rules for the Law of Administration of Tax Collection; Article 2 of Provisional Measures for the Administration of Confidential Information of Taxpayers, Guo Shui Fa [2008] No.93, issued by the SAT on October 9, 2008 and effective on January 1, 2009.

[78] Article 3 of Measures for Public Notice on Outstanding Taxes (For Trial Implementation), Order of the SAT [2004] No. 9, issued by the SAT on October 10, 2004 and effective on January 1, 2005.

the types of taxes owed, the balance of outstanding taxes, and the amount of outstanding taxes that have occurred in the current period.[79] The information can be published on the bulletin board of the tax collection hall and in the public media such as radio, television, newspapers, periodicals, and the Internet.[80]

[79] Article 5 of Order of the SAT [2004] No. 9.

[80] Article 4 of Order of the SAT [2004] No. 9.

15

TAX AUDIT AND APPEAL

15.1 Offices in Charge of Tax Audit

The Law of Administration of Tax Collection authorizes the tax authorities to audit taxpayers and withholding agents. Audit units, which are called audit bureaus, were set up within tax bureaus at each level. An audit bureau is not involved in routine tax collection but is responsible for organizing tax audits, handling tax violation reports, and coordinating with police, prosecutors, and courts for tax criminal investigations. A tax audit can be conducted by the audit bureau within the tax bureau in charge of collection of taxes of a taxpayer or by the audit bureau above the collection bureau. For example, a taxpayer in a large city district can be audited by the audit bureau of the district tax bureau or by the audit bureau of the city tax bureau. Sometimes cross-audits are organized in which a tax bureau in one location audits cases in another location.

Audit bureaus are not the only offices that can conduct tax audits. Other offices within tax bureaus may also perform audits. The SAT has selected 45 large enterprise groups as "large enterprises" that are directly coordinated by the Large Enterprise Administration Department of the SAT. The audit of those large enterprises usually should be coordinated by the SAT. Transfer pricing audit of taxpayers, other than the 45 large enterprises, generally are the territory of International Tax Department of the SAT. Tax bureaus in many locations also have an international tax division. A transfer-pricing audit can be initiated by the international tax division of a local tax bureau, but can also be initiated

by the audit bureau. However, the local tax bureau must obtain approval by the SAT for the commencement and for the completion of a transfer-pricing audit.

15.2 Types of Tax Audits

Tax audits, based on the source and scope, can generally be classified into three categories: special audit, specific case audit, and routine audit. A special audit refers to the campaign of examination and inspection of taxpayers with a focus on specific industries or specific tax issues organized nationwide or region-wide under specific instructions of a higher-level tax bureau. For example, the SAT may instruct the tax bureaus to audit a secondment arrangement between foreign invested companies and their foreign affiliates. In a special tax audit, tax bureaus will audit many taxpayers for the same issue or issues. This type of audit has a specific time period and a specific purpose. Tax bureaus are required to complete all the audits within the specified time period. A tax bureau participating in a special audit also needs to analyze the results of audits and report to the higher-level tax bureau in order for the higher-level tax bureau to formulate a further action plan.

A specific case audit is an audit of a specific taxpayer for alleged specific tax violation. This type of tax audit is usually the result of a report by others of alleged illegal action, a referral by another government agency, a specific instruction of a higher-level tax bureau, or an information exchange. If a tax bureau receives a report alleging the violation of tax law by a taxpayer, the bureau must investigate. Such investigation may lead to an audit. The government encourages people to report the actions in violation of tax law by taxpayers. If someone reports illegal activities of a taxpayer, which leads to a recovery of tax by the tax authority, the government may reward the informer up to RMB100,000.[1]

A routine tax audit is the normal audit conducted by tax bureaus without the specific focus mentioned in the above two categories of audits. The tax bureau may select audit targets either based on specific criteria or on a random basis. The tax bureau can audit the current period however, more often it will audit prior periods. Usually, the audit period is one or two years within the past three filing periods.

In additional to formal audits, tax bureaus may conduct surveys or inspections of taxpayers by asking specific questions or requesting specific information. Such surveys or inspections may be only part of the collection of information by tax bureaus. However, some of those may result in a tax audit or a tax assessment.

[1] Provisional Measures on Awarding Tip-offs against Tax-related Illegal Acts of Taxpayers, Order of the SAT and the MOF [2007] No. 18, issued by the SAT and the MOF on January 13, 2007 and effective on March 1, 2007.

15.3 Procedures of Tax Audits

The tax authorities at all levels should follow tax audit procedures issued by the SAT under the Law of Administration of Tax Collection. The audit procedures issued in 1995[2] were applicable till December 31, 2009. On January 1, 2010, the new Tax Audit Procedures[3] replaced the 1995 procedures. In 1999, the SAT issued the Rules and Procedures of Foreign Related Tax Audit,[4] which provided specific guidelines for the tax authorities to audit foreign related taxpayers, including foreign enterprises and foreign invested enterprises. The 1999 foreign related tax audit procedures and 1995 audit procedures co-existed. Largely due to the two CIT systems prior to 2008, the tax collection and administration of foreign invested enterprises and foreign enterprises were generally handled by special divisions or branches at various levels of tax authorities. After the unification of CIT systems, such special divisions at the SAT as well as tax bureaus in many locations have been dissolved and combined into other divisions. After the issuance of the new Tax Audit Procedures in December 2009, it is not clear whether the 1999 Rules and Procedures of Foreign Related Tax Audit are still valid and enforceable. This Chapter 15.3 primarily summarizes the major procedures provided in the 2009 Tax Audit Procedures.

15.3.1 Jurisdiction of Audit Bureau

Unless otherwise provided by tax laws or administrative regulations or the SAT, an audit bureau of a tax bureau should conduct audits within the jurisdiction of tax administration and collection of the tax bureau. For tax violation acts beyond the above scope, the audit bureau at the location where the illegal act takes place or is found should exercise the audit authority.[5] The audit bureaus of State tax bureaus and the audit bureaus of local tax bureaus in provinces, municipalities, autonomic regions, and the cities specifically designated in the State plan can assign the audit jurisdiction to each level of audit bureau within their respective provinces, municipalities, autonomic regions, and the cities specifically designated in the State plan. Such assignment can be based on (1) the business scale and tax payment amount of taxpayers, (2) the geographic location, industries, types of taxes, and the level of tax burden of taxpayers, (3) the frequency and level of tax violation,

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[2] Tax Audit Procedures, Guo Shui Fa [2009] No. 157, issued by the SAT on December 24, 2009 and effective on January 1, 2010.

[3] Tax Audit Procedures, Guo Shui Fa [1995] No. 226, issued by the SAT on December 1, 1995 and effective on December 1, 1995.

[4] The Rules and Procedures of Foreign Related Tax Audit, Guo Shui Fa [1999] No. 74, issued by the SAT on April 26, 1999.

[5] Article 10 of Guo Shui Fa [2009] No. 157.

(4) the complicity of tax violation, (5) the ownership and organizational structure of taxpayers, and (6) other reasonable methods.[6]

A high level tax bureau may supervise an audit of important tax violation case that is conducted by a lower level tax bureau within its jurisdiction. Such supervised audit will be selected by the high level tax bureau based on the nature, amount of tax, complexity, the level of difficulty, and social influence of the case. The supervised audit can also be proposed by lower level of tax bureau where the matter covers different geographic areas or is complex.[7] Where tax bureaus in more than one location are needed for a supervised audit, the supervising tax bureau may designate one tax bureau as the main bureau to carry out the audit and other bureaus to assist the audit.[8]

An audit conducted by an audit bureau is divided into four steps: target selection, inspection, review and decision, and enforcement. An audit bureau establishes separate divisions; each handles one of the four steps.[9]

15.3.2 AUDIT TARGET SELECTION

The case selection division of an audit bureau should select audit targets based on various channels of information.[10] The case selection division should establish case source information files, including the information of tax collection and audit, the tax violation cases assigned by a higher level of the tax bureau, the tax inspection arranged by a higher level of the tax bureau, the tax violation information provided by other divisions of the tax bureau or an informer, or public information,.[11] The SAT and all levels of State and local tax bureaus should establish tax violation reporting centers within their respective audit bureaus.[12] A tax violation reporting center will analyze the information received and, upon the approval of the head of audit bureau, handle the information based on the facts and circumstances. If the information clearly leads to a suspicion of tax fraud, tax evasion, or other serious tax violation, the information should be input into target source information database. If the information reported is not specific and is not a clear lead, such information will be temporarily held. If the information reported is not within the jurisdiction of the audit bureau, such information should be passed to relevant tax bureaus or other relevant agencies.[13]

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[6] Article 12 of Guo Shui Fa [2009] No. 157.

[7] Article 2 of Provisional Measures on Administration of Supervision of Aduit of Important Tax Violation Cases, Guo Shui Fa [2010] No. 103, issued by the SAT on November 1, 2010 and effective on January 1, 2011.

[8] Article 5 of Guo Shui Fa [2010] No. 103.

[9] Article 5 of Guo Shui Fa [2009] No. 157.

[10] Article 14 of Guo Shui Fa [2009] No. 157.

[11] Article 16 of Guo Shui Fa [2009] No. 157.

[12] Article 17 of Guo Shui Fa [2009] No. 157.

[13] Article 18 of Guo Shui Fa [2009] No. 157.

The case selection division of a tax audit bureau will analyze the target source information via computer, or manually, or both. Once a suspicion of tax violation is identified, the division will send a recommendation for a tax audit to the chief of the tax audit bureau. Upon the approval of the audit bureau chief, the case is formally selected for a tax audit. Such a case will be passed to the audit division of the audit bureau for inspection.[14]

The 1999 Rules and Procedures of Foreign Related Tax Audit mentions five methods to select audit targets:[15]

(1) Large taxpayers. A tax bureau may select large taxpayers as tax audit targets based on specific facts of the region, including the amount of annual tax payment, total investment, revenue, and profits of enterprises.
(2) Industry focus. A tax bureau may analyze industries within the region and select major industries within the region, special industries, or the industries with an unusual tax burden as tax audit targets.
(3) Rotation. A tax bureau may select audit targets using a rotation method, e.g., auditing not least than 30 percent of taxpayers and withholding agents to ensure the full coverage in three years.
(4) Overall assessment. A tax bureau may select tax audit targets by analyzing tax filing data and comparing different types of taxes to evaluate the tax payment conditions of taxpayers and withholding agents.
(5) Other methods. In addition to the above methods, audit targets may be determined in accordance with the arrangements of higher tax authorities, the inspection assistance requirements of other government offices and the information reported by informants.

15.3.3 TAX INSPECTION

When the audit division of a tax audit bureau receives a notice from the case selection division for a tax audit, the audit division should arrange tax officials for on-site tax inspection. The tax inspection normally will be conducted by two tax officials. A written notice should be delivered to the taxpayer/audit target prior to the inspection. The notice should specify the time of inspection and the information required to be prepared. However, if the tax bureau believes that such notice would obstruct the inspection, the tax bureau can commence the inspection without a notice. A tax inspection should be completed within sixty days from its commencement. If an extension of time is needed,

[14] Article 19 of Guo Shui Fa [2009] No. 157.

[15] Article 2.1 of Guo Shui Fa [1999] No. 74.

the approval of the audit bureau chief must be obtained.[16] During the tax inspection, the tax officials can conduct inspections at the taxpayer's premises, request for and review books and records, make enquires and interviews, and inspect the taxpayer's bank accounts. If a taxpayer uses an electronic information system for management and accounting, the tax bureau may request that the taxpayer give the tax bureau access to the system for inspection or provide a copy of original electronic data and system technical materials. If the taxpayer refuses to make the system available to the tax officials or provide the information, the tax bureau may use appropriate technical means to inspect the system or copy data directly provided, however, such inspection or copying should not harm the original data or affect the normal operations of the system.[17]

The tax bureau can directly request, from banks and other financial institutions, information on the bank accounts of the taxpayer or tax withholding agent that are being audited. For bank account information of an enterprise engaged in production or business operations, the approval of the chief of tax bureau is sufficient.[18] If there is obvious evidence that a taxpayer may transfer or hide property to evade tax, an audit bureau may take property preservation measures such as freezing the bank accounts of the taxpayer or seizing the property of the taxpayer upon the approval of the chief of tax bureau.[19] In such action, the tax bureau should deliver a written notice to the taxpayer specifying the action taken and reasons for such action. The taxpayer should be notified of its right for administrative or judicial appeal. In the event of freezing a taxpayer's bank account, the amount frozen should be approximately equal to the amount of tax.[20] The property preservation measure usually should not last longer than six months. In a tax audit of serious tax violation, the property preservation measure can be extended beyond the six-month period upon the approval of the SAT if (1) the case is complex and facts cannot be confirmed during the property preservation measure period; (2) the taxpayer transfers, hides, or destroys books and records or other evidence; (3) the taxpayer refuses to provide relevant information or otherwise obstructs the inspection; or (4) the release of the property preservation measure mostly likely would result in the transfer, hiding or destruction of property by the taxpayer so that the tax cannot be recovered.[21] The audit bureau should release the property preservation measure if the taxpayer has paid tax within permitted period or the property preservation measure has been withdrawn by the administrative appeal agency or a court.[22]

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[16] Article 22 of Guo Shui Fa [2009] No. 157.

[17] Article 23 of Guo Shui Fa [2009] No. 157.

[18] Article 33 of Guo Shui Fa [2009] No. 157.

[19] Article 34 of Guo Shui Fa [2009] No. 157.

[20] Article 35 of Guo Shui Fa [2009] No. 157.

[21] Article 38 of Guo Shui Fa [2009] No. 157.

[22] Article 36 of Guo Shui Fa [2009] No. 157.

When an audit division completes a tax inspection, it should prepare a Tax Audit Report, which should be signed off by the head of the audit division. If tax violation is found, the report should include the following:[23]

(1) Case source;
(2) The basic information of the enterprise being audited;
(3) Time of tax audit and the tax period;
(4) Method of inspection and action taken during inspection;
(5) The facts and nature of tax violation that have been found;
(6) The action of refusal or obstruction, if any, taken by the taxpayer:
(7) The position of taxpayer with respect to the facts found;
(8) Recommendation of tax treatment and penalties and reasons for such recommendation;
(9) Other matters that should be explained; and
(10) Signatures of tax inspection officials and the time for the report.

If no tax violation is found in a tax inspection, the report should state the content of inspection, procedures of inspection, and facts found.

Within five days of completion of tax inspection, the tax audit division should pass the Tax Audit Report, tax audit work papers, and other evidence materials to the review division of tax audit bureau.[24] In any of the following events where the tax inspection cannot be completed, the tax audit division should prepare Application for Termination of Inspection for Tax Violation and pass the relevant documents to the review division for review. The tax inspection will be terminated upon the approval of the chief of audit bureau. Those events include:[25]

(1) The enterprise being audited has been de-registered in accordance with law and there are no properties that can be used for settlement of tax payment or there is no person that has assumed the tax obligation of the enterprise in accordance with law.
(2) The time period permitted to seek tax recovery for the violation has passed.
(3) Other reasons that a tax inspection can be termination as provided by law, administrative regulations, or the SAT.

[23] Article 42 of Guo Shui Fa [2009] No. 157.
[24] Article 43 of Guo Shui Fa [2009] No. 157.
[25] Article 45 of Guo Shui Fa [2009] No. 157.

15.3.4 REVIEW AND DECISION OF TAX AUDIT

After the review division of a tax audit bureau receives a Tax Audit Report from the tax audit division, it should review the report and other relevant information.[26] The review will be focused on (1) whether the enterprise being audited is an appropriate entity; (2) whether the facts of tax violation are clear, evidence is sufficient, data is accurate, and the information is complete; (3) whether the relevant law and regulations are correctly applied; (4) whether legal procedures are followed; (5) whether the tax bureau abuses its power or exercises power beyond its authority; and (6) whether the recommendation for tax treatment and administrative penalties is appropriate.[27] If the review division finds that (1) an incorrect person is an audited person, (2) facts are unclear or evidence is insufficient for tax violation, (3) the procedures do not comply with law, (4) documents prepared by the tax audit division are not in correct format or are incomplete, or (5) other situations where supplementary investigation is required, then the review division can return the Tax Audit Report to the tax audit division for supplementary investigation and completion.[28] If the review division believes that the tax treatment and administrative penalties recommended by the audit division are inappropriate, it should propose new recommendations.[29] The review division generally should complete a review within 15 days, excluding time for supplementary investigation by the audit division and the time for consultation on tax policies with higher tax authority, after receiving the Tax Audit Report.[30]

The taxpayer should be notified of proposed tax treatment and administrative penalties.[31] The taxpayer has the right to express its opinion.[32] The review division can make four types of decisions:

(1) If the tax violation is found and the review division believes that tax assessment is necessary, it should prepare a Tax Treatment Decision. The Tax Treatment Decision should include, among other things, the statement of facts, the basis of tax treatment, the amount of tax and late payment charges, and the deadline and place for such tax and late payment charge payments.[33] Where the audit results in an increase of taxable income of prior years, the tax loss carryovers available in the years adjusted should be allowed to offset the increase of

[26] Article 46 of Guo Shui Fa [2009] No. 157.
[27] Article 47 of Guo Shui Fa [2009] No. 157.
[28] Article 48 of Guo Shui Fa [2009] No. 157.
[29] Article 49 of Guo Shui Fa [2009] No. 157.
[30] Article 50 of Guo Shui Fa [2009] No. 157.
[31] Article 51 of Guo Shui Fa [2009] No. 157.
[32] Article 52 of Guo Shui Fa [2009] No. 157.
[33] Articles 55 and 56 of Guo Shui Fa [2009] No. 157.

taxable income. CIT for the years should be computed only on the portion of such increase after the use of the loss carryvoers.[34]

(2) If tax violation is found and the review division believes that tax administrative penalty is necessary, it should prepare a Tax Administrative Penalty Decision. The Tax Administrative Penalty Decision should include, among other things, the facts of tax violation and relevant tax periods, the type of administrative penalty and basis, the method, time, and place for completion of such penalty.[35]

(3) If the tax violation is light and the law allows possibility of not imposing an administrative penalty, the review division should prepare a Decision on Not Imposing Tax Administrative Penalty. The decision should include, among other things, the facts of tax violation and relevant tax periods, and the basis for not imposing tax of administrative penalty.[36]

(4) If the review division believes that there is no tax violation, it should prepare a Conclusion of Tax Audit. The Conclusion of Tax Audit should include, among other things, the scope of tax audit and relevant tax periods, and the conclusion of inspection.[37]

If the tax violation involves a suspected criminal act, the review division should prepare a Report Forwarding Suspected Criminal Case, and, upon the approval of the head of tax bureau, pass the report and an investigation report to the public security agency. The tax bureau should also provide the public security agency with the copies of Tax Treatment Decision, Tax Administrative Penalty Decision, major evidence for the suspected criminal act, the payments for tax and late payment charges, and the evidence that the taxpayer has received administrative penalty.[38]

15.3.5 ENFORCEMENT OF TAX AUDIT

Where a taxpayer has not paid tax within the time period as specified in a Tax Treatment Decision, upon the approval of the head of tax bureau, the enforcement division of tax audit bureau can enforce the Tax Treatment Decision directly or apply to the People's Court for enforcement.[39] Where a taxpayer has not paid an administrative penalty and has not applied for an administrative appeal or filed a judicial appeal within

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[34] SAT Gong Gao [2010] No. 20.

[35] Articles 55 and 57 of Guo Shui Fa [2009] No. 157.

[36] Articles 55 and 58 of Guo Shui Fa [2009] No. 157.

[37] Articles 55 and 59 of Guo Shui Fa [2009] No. 157.

[38] Articles 60 of Guo Shui Fa [2009] No. 157.

[39] Articles 62 of Guo Shui Fa [2009] No. 157.

the time period as specified in a Tax Administrative Penalty Decision, upon the approval of the head of tax bureau, the enforcement division of tax audit bureau can enforce the Tax Administrative Penalty Decision directly or apply to the People's Court for enforcement.[40]

In a direct enforcement action, the tax audit bureau can directly collect taxes, late payment charges, and administrative penalties by garnishing the bank accounts of the taxpayer upon delivering a notice on withholding tax to the bank and other financial institutions.[41] The tax audit bureau can seize and auction the property of the taxpayer and withhold the taxes, late payment charges, and administrative penalties from the auction proceeds.[42]

15.4 Tax Administrative Appeal

When a taxpayer disagrees with the final decision of the tax audit, it may apply for a tax administrative appeal. A tax administrative appeal, however, covers a broad range of decisions or acts made by the tax authorities, in addition to a decision of tax audit. An applicant may request a tax administrative appeal for matters such as the determination of taxpayer; tax scope; tax incentives; applicable rate; the time, location and method of tax payment; amount of tax; late payment charge; and administrative penalty. The administrative appeal scope also includes the decision of the tax authority on enforcement of tax collection (e.g., the seizing of the bank account and auctioning of properties).[43]

A tax administrative appeal should be made to the tax authority one level higher than the authority that makes the original decision or act. Where the original decision making authority is the Local Tax Bureau of a province, municipality, or autonomous region, the taxpayer may appeal to either the SAT or the People's Government of the province, municipality, or autonomous region.[44] If the original decision is made by a city specifically designated in the state plan, the appeal should be made to the provincial tax authority where the city is located.[45] If the original decision is made by the SAT, the applicant may apply for a tax administrative appeal to the SAT. However, if the applicant disagrees with the result of the appeal, it may either sue the SAT at the People's Court or apply for a ruling from the State Council. The State Council's decision is final.[46] When a tax audit

[40] Articles 63 of Guo Shui Fa [2009] No. 157.

[41] Articles 66 of Guo Shui Fa [2009] No. 157.

[42] Articles 67 of Guo Shui Fa [2009] No. 157.

[43] Article 8 of Rules for Tax Administrative Appeal (Trial Implementation), Order of SAT [2004] No. 8, issued by the SAT on February 24, 2004 and effective on May 1, 2004.

[44] Article 10 of Order of SAT [2004] No. 8.

[45] Article 12 of Order of SAT [2004] No. 8.

[46] Article 11 of Order of SAT [2004] No. 8.

is conducted by the audit bureau of a district tax bureau, the authority at one level higher is the district bureau itself even if the audit bureau is an audit arm of the district tax bureau. If a withholding agent disagrees with the decision or act concerning the tax withholding, the withholding agent should appeal to the tax authority at one level above the tax authority in charge of the withholding. If a State tax bureau and a local tax bureau conduct a joint tax audit, the State tax bureau and the local tax bureau should make separate decisions within their respective scope of authority and should not make a joint specific administrative act. If a taxpayer disagrees with a joint specific act made by a State tax bureau and a local tax bureau, it may appeal to the SAT. If a taxpayer disagrees with a specific act jointly made by a tax bureau and another administrative office, the taxpayer may appeal to the common government authority in charge of both the tax bureau and the other administrative office. For appeal of an action made by an agency other than the SAT, a provincial level tax bureau, or a tax bureau of city specifically designated in the State plan, as an alternative to directly appealing to the relevant authorities, the taxpayer may submit an application for tax administrative appeal to the People's Government at the county level where the act took place; the local government will forward the appeal application to the appropriate authority.[47]

An applicant should apply for a tax administrative appeal within sixty days after being notified of the specific administrative act conducted by the tax authorities. Where the statutory time limit is delayed due to acceptable reasons like force majeure or the obstacles set by the respondent tax authorities, the application time limit shall continue to count from the date of the removal of the obstacles.[48] An application for a tax administrative appeal can be made either in writing or orally; in case of oral application, the appeal authorities should record the application in writing, including the basic description of the applicant, the request for administrative appeal, and the key facts, arguments, and the time of the oral appeal.[49] Where an applicant appeals to a tax and late payment charge assessment, it must first pay the amount of tax and the late payment charges or provide the relevant guaranty within the time limit as specified by the tax authorities according to laws and administrative regulations. And then the applicant may apply for the tax administrative appeal within sixty days after receiving the confirmation of tax payment or the provision of guarantee issued by the tax authority making the administrative act. The guarantee provided by the applicant may include personal guarantees and provision of security interest in properties. The tax authority making the specific administrative act should examine the qualification and reputation of the guarantor and the quality of

[47] Article 12 of Order of SAT [2004] No. 8.

[48] Article 13 of Order of SAT [2004] No. 8.

[49] Article 16 of Order of SAT [2004] No. 8.

pledged properties. The tax authority has the right to refuse the guarantee for those unqualified.[50]

The tax authority receiving a tax administrative appeal should determine whether it accepts the application for administrative appeal within five days of the receipt of application. The tax authority should notify the applicant if it rejects the application. The authority may reject an application if (1) the matter is not within the scope of administrative appeal; (2) the application exceeds the permitted time limit; (3) there is no clear respondent; (4) the application was filed with other legally authorized authority for administrative appeal and has been rejected; (5) a legal action has been brought to and accepted by a People's Court; (6) the applicant has not paid tax and late payment charges or provided valid guarantee for dispute concerning tax payments; or (7) the applicant is not qualified for the application. If the appeal tax authority fails to notify the applicant of the rejection of an application within the time limit, the application for tax administrative appeal is deemed to have been accepted.[51] If an application satisfies the requirements for administrative appeal, the date of acceptance is the date that the authority receives the application. The authority should notify the applicant of the acceptance of application.[52]

The appeal authority should forward a copy of written application or record of oral application to the respondent (i.e., relevant tax authority) within seven days of acceptance of application. The respondent should submit a written reply and provide evidence and basis for its original administrative act and other relevant materials within ten days after receiving the copy of the appeal application.[53] Administrative appeal is principally conducted through the review of written materials. Where, however, the applicant requests, or the governmental legal affairs body believes necessary, the opinions of the applicant, respondent, and the third party should be heard, and an investigation may be conducted to the relevant organizations and persons.[54] The appeal authority should fully examine the factual evidence, legal procedures, legal basis, legality and appropriateness of their right and obligation by which the respondent had made the specific administrative act.[55] The burden of proof for the appropriateness of the administrative act is on the respondent.[56]

The appeal authority should render the review decision within sixty days after accepting the application for appeal. If the authority is not able to make a decision within the time period due to the complexity of the case, the time may be extended for not more

[50] Article 14 of Order of SAT [2004] No. 8.

[51] Article 20 of Order of SAT [2004] No. 8.

[52] Article 21 of Order of SAT [2004] No. 8.

[53] Article 37 of Order of SAT [2004] No. 8.

[54] Article 35 of Order of SAT [2004] No. 8.

[55] Article 36 of Order of SAT [2004] No. 8.

[56] Article 28 of Order of SAT [2004] No. 8.

than thirty days upon the approval of the chief of the appeal authority and the notice to the applicant and the respondent. Upon the completion of review, the appeal authority should deliver a decision in writing, which becomes effective once delivered.[57]

Before the appeal authority renders a decision on administrative appeal, the applicant may withdraw the application at any time. However, such withdrawal will prevent the applicant from filing another administrative appeal based on the same facts or reason.[58]

The appeal authority may make one of three types of decisions on an administrative appeal:[59]

(1) The authority may uphold the original decision made by the respondent.
(2) If the appeal concerns a non-act of the respondent, the appeal authority may demand that the respondent perform the act required by law.
(3) The appeal authority may rescind or change the original decision made by the respondent, or declare the act made by the respondent invalid. In a case of rescindment or declaration of invalidity of the act, the appeal authority may order the respondent to reconsider its specific administrative act within a specified time period. The basis for the appeal authority to rescind, change, and declare invalidity of the original administrative act includes unclear facts and insufficient evidence, an inappropriate legal basis, incorrect legal procedures, exceeding or abusing power, and the obvious inappropriateness of specific administrative acts. In a case in which the appeal authority orders the respondent to reconsider the administrative act, the respondent should not re-render the same or similar decision based on the same facts and arguments. Where, however, the appeal authority withdraws the original decision because of inappropriate procedures, the respondent is not prevented from making the same decision.

When an applicant applies for a tax administrative appeal, it may request administrative compensation. The appeal authority should grant compensation for those satisfying the rules of State Compensation Law. The appeal authority should decide the compensation matter at the time when it decides to withdraw or change the decision of the respondent or hold the act invalid. Where the applicant does not request administrative compensation and the appeal authority decides to withdraw or change the decision of the respondent on the taxes, late payment charges, fines, or the seal-up or detention of property of the applicant, the appeal authority should order the respondent to refund the relevant taxes, late payment charges and fines and relieve the property. As an alternative,

[57] Article 43 of Order of SAT [2004] No. 8.

[58] Article 38 of Order of SAT [2004] No. 8.

[59] Article 41 of Order of SAT [2004] No. 8.

the appeal authority may order the respondent to compensate the applicant with equivalent payment.[60]

15.5 Tax Litigation

15.5.1 JURIDICAL SYSTEM

China has a four-level court system. The Supreme People's Court is the highest level of court of the land, which supervises the administration of justice by all subordinate local and special people's courts. High people's courts are the second high level of court, which are at the level of the provinces, autonomous regions, and municipalities. Intermediate people's courts are at the level of prefectures, autonomous prefectures, and prefecture-level cities. Intermediate people's courts are also set within municipalities under the high people's court of the municipalities. Basic people's courts are at the level of counties, county-level cities, and districts. Additionally, there are special courts such as the military court, railway transportation court, maritime court, and forestry court. There is no special tax court in China. Tax cases are normally handled by local people's courts.

China adopts a two-hearing system in the trial process. If a case is first heard at a basic people's court, it could be appealed to the intermediate people's court supervising the basic people's court. Similarly, if a case starts at an intermediate people's court, it can be appealed to the high people's court supervising the intermediate people's court. The judgment by the court in second instance becomes final and enforceable.

15.5.2 JUDICIAL TRIAL IN FIRST INSTANCE

The legal remedy to a tax administrative appeal is a lawsuit brought by a taxpayer or other relevant party against the tax authority. The PRC Law of Administrative Procedures[61] governs the process of administrative litigations including appeals of tax administrative appeals. Basic people's courts have jurisdiction over tax administrative cases as the trial court at the first instance.[62] However, if a decision of tax administrative appeal is made by the SAT or a tax authority at the provincial level, the case should be filed at the intermediate people's court. An intermediate people's court can also hear, at first instance, important or complex tax cases within its jurisdiction.[63] Such important or complex cases

[60] Article 42 of Order of SAT [2004] No. 8.

[61] The PRC Law of Administrative Procedures, passed by the NPC on April 4, 1989 and effective on January 1, 1990.

[62] Article 13 of Law of Administrative Procedures.

[63] Article 14 of Law of Administrative Procedures.

include important cases involving foreign countries, Hong Kong, Macau, and Taiwan.[64] A high people's court can hear, at first instance, important or complex tax cases within its jurisdiction.[65] The Supreme People's Court can hear, at first instance, important or complex tax cases within the country.[66] The local people's court to conduct the first hearing is the people's court where the tax authority making the original decision/administrative act is located. If the decision is appealed to a higher level of tax authority and the appeal tax authority changes the decision of original tax authority, the first hearing case may also be filed at the people's court where the appeal tax authority is located.[67] Where two people's courts have jurisdiction over one case in first instance, the taxpayer can select one to file appeal. If the case is filed at more than one court, each of which has jurisdiction, the court that receives the case first should exercise the jurisdiction over the case.[68] If a people's court cannot exercise its power to try a case due to special circumstances, a higher-level court supervising the first court should appoint the court to take the case.[69] A higher level of people's court may try a case, at first instance, over which a lower people's court has jurisdiction. A higher level of people's court may delegate a case to a lower court for first instance trial. If a lower people's court has jurisdiction over a case, however, it believes that it is more appropriate to have a higher-level court try a case as a first-instance court, the lower court may report to the higher-level court and the higher-level court should determine the first-instance trial court.[70]

An applicant of tax administrative appeal (e.g., a taxpayer) may appeal the decision on administrative appeal to a people's court within 15 days after it receives the administrative appeal decision if the applicant disagrees with such decision.[71] If the tax appeal authority rejects an application for administrative appeal or does not apply within time limit, the applicant may appeal to a People's Court within 15 days after receiving the notice of rejection or the expiration of administrative review period, including extension of time.[72]

A people's court should decide whether to accept or dismiss a case within seven days after receiving a complaint. If the court decides not to accept the case, the court will issue a ruling to dismiss the case; the plaintiff (i.e., taxpayer) can appeal the court's ruling to a

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[64] Article 8 of Interpretations on Certain Issues Concerning the Enforcement of the PRC Administrative Procedures, Fa Shi [2000] No. 8, issued by the Supreme People's Court on March 8, 2000 and effective on March 10, 2000.

[65] Article 15 of Law of Administrative Procedures.

[66] Article 16 of Law of Administrative Procedures.

[67] Article 17 of Law of Administrative Procedures.

[68] Article 20 of Law of Administrative Procedures.

[69] Article 22 of Law of Administrative Procedures.

[70] Article 23 of Law of Administrative Procedures

[71] Article 38 of Law of Administrative Procedures; Article 22 of Order of SAT [2004] No. 8.

[72] Article 22 of Order of SAT [2004] No. 8.

higher-level court.[73] Such appeal should be made within ten days after the delivery of ruling.[74] If the court accepts a case, it should forward a copy of the complaint to the defendant/tax authority within five days of acceptance of the case. The defendant should submit a written answer to the complaint and provide materials in relation to its administrative act within ten days after receiving the copy of the complaint. The court should forward a copy of the defendant's answer to the plaintiff within five days after receiving the document.[75] The people's court should conduct hearings open to the public unless the case involves State secrecy, individual privacy, or as otherwise provided by law.[76]

Before the court renders a judgment, the plaintiff may apply for withdrawing the case; where the defendant changes its act and the plaintiff agrees, the plaintiff also may apply for a withdrawal. However, it is the court that will determine whether the application for withdrawal is granted.[77]

When a people's court tries an administrative case, it should render a judgment based on facts and relied-on laws.[78] The court should also makes its decision by reference of the published administrative regulations, orders, and rules issued by the departments of State Council, the published local regulations and rules issued by the governments of provinces, municipalities, autonomous regions, the capital cities and prefectures of provinces and autonomous regions, and other large cities approved by the State Council. If the people's court believes that the local regulations are inconsistent with the regulations issued by the departments of the State Council or that the regulations issued by the departments of the State Council themselves are inconsistent, the Supreme People's Court should request that the State Council make interpretations or ruling.[79]

The people's court may render the following judgments for an administrative litigation:[80]

(1) The court may uphold the original decision made by the defendant tax authority.
(2) The court may rescind or partially rescind the decision/act of the tax authority. The court may also remand the case back and order the tax authority to re-render its specific administrative decision/act. The basis for the court to rescind or remand the tax authority's decision may include unclear facts and insufficient evidence, inappropriate legal basis, incorrect legal procedures,

[73] Article 42 of Law of Administrative Procedures.
[74] Article 57 of Law of Administrative Procedures.
[75] Article 43 of Law of Administrative Procedures.
[76] Article 45 of Law of Administrative Procedures.
[77] Article 51 of Law of Administrative Procedures.
[78] Article 4 of Law of Administrative Procedures.
[79] Article 53 of Law of Administrative Procedures.
[80] Article 54 of Law of Administrative Procedures.

exceeding or abusing power, and the obvious inappropriateness of specific administrative act.

(3) If the complaint concerns a non-act of the tax authority, the court may demand that the tax authority perform the act required by law.

(4) If an administrative penalty is obvious unfair, the court may change the penalty.

If a people's court remands the case and orders the tax authority to re-render its decision, the tax authority cannot issue the same or almost same decision based on the same facts and arguments.[81]

If the tax authority's act is in compliance with administrative regulations, the court will not judge the reasonableness of such action. The court will dismiss a complaint that merely argues the act of tax authority is unreasonable. The court will also not support a complaint in which the tax authority's act is valid in accordance with law but such act should be changed or canceled because of a change of law and policy.[82] The court is not allowed to increase the penalty to the defendant.[83] As such, the court cannot impose additional tax, late payment charges, and administrative penalties to a taxpayer in an administrative litigation.

The people's court at the first trial should render a judgment within three months from the date of accepting the case. In special circumstances, the time period can be extended upon the approval of a high people's court. If the first trial court is a high people's court, the approval for extension of time must be made by the Supreme People's Court.[84]

15.5.3 JUDICIAL TRIAL IN SECOND INSTANCE

If the plaintiff and/or the tax authority disagrees with the judgment of court at the first instance, the disagreeing party may appeal the case to the people's court at a higher level within 15 days after the delivery of judgment. The judgment becomes effective if appeal has not been made within the prescribed time period.[85]

The people's court handling an appeal case should render a final judgment within two months from the date of receiving the appeal. In special circumstances, the time period can be extended upon the approval of a high people's court; if the appeal court is a high people's court, the approval for extension of time must be made by the Supreme People's

[81] Article 55 of Law of Administrative Procedures.

[82] Article 56 of Fa Shi [2000] No. 8.

[83] Article 55 of Fa Shi [2000] No. 8.

[84] Article 57 of Law of Administrative Procedures.

[85] Article 58 of Law of Administrative Procedures.

Court.[86] If the appeal court believes that facts are clear, the court may render a judgment based on the review of documents,[87] rather than an actual trial/hearing.

The people's court handling an appeal may render the following judgments:[88]

(1) Where the facts verified by the court in the first instance are clear and law and regulations are correctly applied by the court in the first instance, the appeal court should dismiss the appeal and sustain the original judgment.
(2) Where the facts verified by the court in the first instance are clear but law and regulations are incorrectly applied by the court in the first instance, the appeal court should reverse and amend the original judgment.
(3) Where (i) the facts verified by the court in the first instance are not clear, (ii) there is insufficient evidence, or (iii) the inappropriate legal procedures were applied by the court in the first instance that may prejudice the original judgment, the appeal court should revoke the original judgment and remand the case to the court in the first instance for a retrial. However, the appeal court may render a new judgment instead of remanding the case. If a retrial is conducted after remanding the case back to the court in the first instance, both parties can appeal the new judgment rendered in the retrial.

A judgment or order of a people's court in a trial in the second instance is a final judgment or order; parties cannot make further appeal.[89]

15.5.4 PETITION FOR REVIEW OF LEGALLY EFFECTIVE JUDGMENT

In spite of the two-hearing system, a party may petition for additional judicial review after a judgment becomes final and enforceable. In a judicial appeal of a tax case, if a party believes that the judgment or order of the court in the second instance is not correct, it may file a petition for revision of the judgment or order with the people's court that renders the judgment or order or the people's court at higher level. This petition does not affect the enforcement of the final judgment or order.[90] A party may also file a petition for revision of the judgment or order issued by the people's court in the first instance where no appeal is made within the permitted time period and the judgment or order has become effective. The court receiving the petition has discretionary power to determine whether to accept the case or not. If the president of a people's court believes that the law

[86] Article 60 of Law of Administrative Procedures.
[87] Article 59 of Law of Administrative Procedures.
[88] Article 61 of Law of Administrative Procedures.
[89] Article 6 of Law of Administrative Procedures.
[90] Article 62 of Law of Administrative Procedures.

and regulations were inappropriately applied to a judgment or order rendered by the people's court and that it is necessary to reopen the case, he or she should submit the case to the judicial committee of the court for a determination as to whether a retrial should be conducted. If a people's court at a level higher than the court issuing a legally effective judgment or order finds that the law and regulations were inappropriately applied to a judgment or order rendered by the lower court, the higher-level court may decide to hear the case by itself or to instruct that the lower court retry the case.[91]

15.5.5 ROLE OF PROCURATORATE

The people's procuratorates have right to exercise legal supervision power in administrative litigations.[92] If a people's procuratorate finds that the law and regulations were inappropriately applied to a judgment or order that have become effective, it may protest the court's decision in accordance with trial supervision procedures.[93]

15.5.6 ENFORCEMENT OF JUDGMENT

The taxpayers/withholding agents and the tax authorities must comply with the final judgment or order issued by people's courts. If a taxpayer/withholding agent refuses to implement a court's final decision, the tax authority may seek the enforcement of judgment or order at the people's court trying the case in first instance. If the tax authority refuses to implement the court's decision, the taxpayer/withholding agent may seek the enforcement of judgment or order at the people's court trying the case in first instance; the court may take the following actions:[94]

(1) The court may notify the bank to allocate funds from the bank account of the tax authority directly if the tax authority should refund a penalty or pay compensation in accordance with the judgment.
(2) If the tax authority does not comply with the judgment within the specified time period, the court may impose a penalty of RMB50 to RMB100 per day commencing on the date after the last day of such period.
(3) The court may make judicial recommendations to the executive agency supervising the tax authority, supervision department, and human resources department. The agency receiving the recommendation should take disciplinary

[91] Article 63 of Law of Administrative Procedures.

[92] Article 10 of Law of Administrative Procedures.

[93] Article 64 of Law of Administrative Procedures.

[94] Article 65 of Law of Administrative Procedures.

action in accordance with relevant rules, and should notify the court of the result.

(4) In serious cases, the court may seek to impose criminal sanctions against the persons directly in charge and other persons held directly responsible for the refusal to comply with the judgment.

To apply for enforcement of a judgment or an order at a court, the tax authority or an enterprise should submit an application within 180 days of the delivery of judgment or order.[95]

15.5.7 COMPENSATION TO TAXPAYERS

If an administrative act violates the legal right of a citizen or a legal person, resulting in injury or damage to the person, the injured party has the right to request compensation in an administrative litigation. While the dispute regarding the administrative act cannot be mediated, the parties are allowed to settle the compensation dispute through a court mediation.[96]

[95] Article 84 of Fa Shi [2000] No. 8.

[96] Article 67 of Law of Administrative Procedures.

APPENDIX 1

Corporate Income Tax Law of the People's Republic of China (unofficial English translation)

CORPORATE INCOME TAX LAW OF THE PEOPLE'S REPUBLIC OF CHINA

(Passed at the 5th Full Session of the 10th National People's Congress of China on March 16, 2007 and issued by Order of President No. 63 on March 16, 2007)

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CHAPTER 1 GENERAL PROVISIONS

Article 1 In the People's Republic of China, enterprises and other organizations that derive income (hereinafter referred to as enterprises) shall be the taxpayers of the Corporate Income Tax and shall pay Corporate Income Tax in accordance with the provisions of this Law.

This Law shall not apply to sole proprietor enterprises and partnership enterprises.

Article 2 Enterprises are classified as resident enterprises and non-resident enterprises.

A resident enterprise as referred to in this Law is an enterprise that is established in accordance with the laws of China, or an enterprise that is established in accordance with the laws of foreign countries (regions) but whose place of effective management is located in the territory of China.

A non-resident enterprise as referred to in this Law is an enterprise that is established under the laws of foreign countries (regions) with the place of effective management located outside the territory of China, but which has an establishment or place of business in China, or which does not have an establishment or place of business in China, but derives income from sources within China.

Article 3 A resident enterprise shall pay Corporate Income Tax on its income from sources within and outside China.

A non-resident enterprise with an establishment or place of business in China shall pay Corporate Income Tax on its China source income derived by such establishment or place of business and on its foreign source income which is effectively connected with such establishment or place of business.

A non-resident enterprise, that does not have any establishment or place of business in China, or that has an establishment or place of business in China but whose income is not effectively connected with such establishment or place of business, shall pay Corporate Income Tax on its China source income.

Article 4 Corporate Income Tax rate shall be 25%.

The tax rate applicable to non-resident enterprises deriving income as specified in paragraph 3 of Article 3 of this Law shall be 20%.

CHAPTER 2 TAXABLE INCOME

Article 5 The taxable income of an enterprise in a tax year shall be its total revenue for the tax year less its non-taxable revenue, tax-exempt revenue, various deductions and allowable losses carried forward from prior years.

Article 6 The total revenue of an enterprise refers to both the monetary revenue and non-monetary revenue derived by the enterprise from various sources, which shall include:

(1) Revenue from the sale of goods;
(2) Revenue from the provision of services;
(3) Revenue from the transfer of property;
(4) Dividends, profit distributions and other returns on equity investments;
(5) Interest income;
(6) Rental income;
(7) Royalty income;
(8) Donation income; and
(9) Other revenue.

Article 7 The following revenue out of the total revenue shall be non-taxable:

(1) Fiscal appropriation;

(2) Government administrative charges and government funds collected according to the relevant laws and subject to government's financial administration; and
(3) Other non-taxable revenue stipulated by the State Council.

Article 8 Reasonable expenses related to the earning of revenue and actually incurred by an enterprise, including costs, expenses, taxes, losses and other expenses, are deductible in computing taxable income.
Article 9 Donations made by an enterprise for public welfare are deductible in computing taxable income subject to the limit of no more than 12% of total profit in the current year.
Article 10 The following items are not deductible in computing taxable income:

(1) Dividends, profit distributions and other returns on equity investments paid to investors;
(2) Corporate Income Tax;
(3) Late payment charges on tax underpayment;
(4) Fines, penalties, and losses resulting from confiscation of property;
(5) Donations other than those stipulated in Article 9 of this Law;
(6) Sponsorship expenses;
(7) Unapproved provisions; and
(8) Other expenditures incurred that are unrelated to the earning of revenue.

Article 11 In computing its taxable income, an enterprise may deduct depreciation expenses on its fixed assets where the expenses are calculated in accordance with the relevant provisions.
Depreciation expenses on the following fixed assets are not deductible:

(1) Fixed assets not in use other than houses and buildings;
(2) Fixed assets leased from another party under an operating lease;
(3) Fixed assets leased to another party under a finance lease;
(4) Fixed assets fully depreciated but still in use;
(5) Fixed assets that are unrelated to business activities;
(6) Land appraised independently and booked as fixed assets; and
(7) Other non-depreciable fixed assets.

Article 12 In computing its taxable income, an enterprise can deduct the amortization expenses on its intangible assets where such expenses are calculated in accordance with the relevant provisions.
Amortization expenses on the following intangible assets are not deductible:

(1) Expenses incurred by an enterprise in the development of its own intangible assets that have already been deducted in computing the taxable income of the enterprise;
(2) Self-generated goodwill;
(3) Intangible assets unrelated to the business activities; and
(4) Other intangible assets on which amortization expenses are not allowed to be deducted.

Article 13 In computing its taxable income, an enterprise can deduct the following expenses where such expenses are treated as long-term deferred expenses and amortized in accordance with the relevant provisions:

(1) Expenses incurred for the alteration of fully depreciated fixed assets;
(2) Expenses incurred for the alteration of fixed assets leased from another party;
(3) Expenses incurred for the overhaul of fixed assets; and
(4) Other expenses that shall be treated as long-term deferred expenses.

Article 14 The **cost** of the investment assets of an enterprise shall not be deducted in computing the taxable income of an enterprise during the period of the external investment.
Article 15 In computing its taxable income, the cost of inventories used or sold by an enterprise, which is computed in accordance with the relevant provisions, is deductible.
Article 16 Where an enterprise transfers its assets, the net asset value of such assets is deductible in computing its taxable income.
Article 17 Where an enterprise calculates its Corporate Income Tax on a consolidated basis, losses incurred by its overseas business establishment shall not be offset against the profits from its business establishments in China.
Article 18 Losses incurred by an enterprise in a tax year are allowed to be carried forward and utilized against the income of subsequent years. The loss carry-forward period shall not exceed 5 years.
Article 19 The taxable income of a non-resident enterprise as described in paragraph 3 of Article 3 of this Law shall be calculated according to the following methods:

(1) In the case of dividends, profit distributions and other returns on equity investments, interest, rentals and royalties, the taxable income shall be the entire amount of revenue;
(2) In the case of capital gains from transfer of properties, the taxable income shall be the entire amount of revenue less net property value; and
(3) In the case of other income, the taxable income shall be calculated with reference to the two methods mentioned above.

Article 20 Detailed measures regarding the specific scope of, and the standards for, revenue and deductible expenses, and detailed measures on the tax treatment of assets as stipulated in this Chapter, shall be issued by the departments of the State Council in charge of finance and taxation.
Article 21 In computing its taxable income, if there is inconsistency between the financial and accounting treatment adopted by an enterprise and provisions of the tax laws and regulations, the taxable income shall be calculated in accordance with the tax laws and regulations.

CHAPTER 3 TAX PAYABLE

Article 22 The amount of tax payable by an enterprise shall be equal to the enterprise's taxable income times its applicable tax rate, less the amount of its allowable reductions, exemptions and tax credits pursuant to the provisions of this Law on tax incentives.

Article 23 Foreign income tax paid on the following income may be credited against the tax payable by an enterprise in the current period, provided that the amount of such tax credit shall not exceed the amount of tax otherwise payable on such income calculated in accordance with the provisions of this Law; the amount of foreign tax paid in excess of the allowable tax credit limit in the current period may be carried forward and credited against the tax payable in any of the subsequent five years to the extent that in each of those years there remains unused credit limit for that year after the utilization of the foreign tax credit arising in that year:

(1) Taxable income from sources outside China derived by a resident enterprise; and
(2) Taxable income derived from sources outside China by a non-resident enterprise, which is effectively connected with the establishment or place of business of such non-resident enterprise within China.

Article 24 For foreign-sourced dividends and profit distributions or other returns on equity investments that are distributed to a resident enterprise by a foreign enterprise directly or indirectly controlled by the resident enterprise, the portion of the income tax actually paid outside China by a foreign enterprise that is attributable to such dividends, profit distributions or other returns on equity investments may be used by the resident enterprise as a foreign income tax credit and credited up to the limit specified in Article 23 of this Law.

CHAPTER 4 TAX INCENTIVES

Article 25 Corporate Income Tax incentives are available to industries and projects that are eligible for key support from the State or whose development is encouraged by the State.
Article 26 The following revenue derived by an enterprise shall be exempt from tax:

(1) Interest from state treasury debts;
(2) Qualified dividends, profit distributions and other returns on equity investments derived by a resident enterprise from another resident enterprise;
(3) Dividends, profit distributions and other returns on equity investments derived by a non-resident enterprise from a resident enterprise, to the extent that the dividends, profit distributions and other returns are effectively connected with the establishment or place of business in China of the non-resident enterprise; and
(4) Revenue of a qualified non-profit organization.

Article 27 The following income derived by an enterprise may be eligible for exemption from or reduction of Corporate Income Tax:

(1) Income derived from projects in the agriculture, forestry, animal husbandry or fishery industry;
(2) Income derived from investment in or operation of public infrastructure projects eligible for key support from the State;
(3) Income derived from qualified environmental protection and energy or water conservation projects;

(4) Income derived from technology transfers that meet certain conditions; and
(5) Income described in paragraph 3 of Article 3 of this Law.

Article 28 The Corporate Income Tax rate applicable to small-scale enterprises with low profitability that meet certain conditions shall be reduced to 20%.

The Corporate Income Tax rate applicable to High-and-New Technology Enterprises eligible for key support from the State shall be reduced to 15%.

Article 29 The autonomous government authorities of ethnic autonomous regions may decide to grant a reduction or exemption of Corporate Income Tax to the enterprises located within their jurisdictions for such part of tax as retained by ethnic autonomous regions. Such deductions or exemptions made by autonomous prefectures and counties shall be subject to the approval from the People's Governments of the relevant provinces, autonomous regions and municipalities.

Article 30 In computing its taxable income, an enterprise may claim additional deduction on the following expenses:

(1) Research and development expenses incurred for the development of new technologies, new products and new technological processes; and
(2) Salary expenses paid to disabled personnel employed by the enterprise and other personnel whose employment is encouraged by the State.

Article 31 A venture capital enterprise that makes venture capital investment in the areas eligible for key support and encouragement from the State shall be eligible to set off a certain percentage of its investment against its taxable income.

Article 32 If it is necessary to accelerate depreciation of an enterprise's fixed assets due to such reasons as technology advancement, the depreciation period may be shortened or an accelerated depreciation method may be adopted.

Article 33 Revenue derived from the manufacture of products that are in line with state industrial policy and involve the synergistic utilization of resources may be reduced in computing the taxable income of an enterprise.

Article 34 A certain percentage of the investment made by an enterprise on the purchase of special equipment for the purpose of environmental protection, energy and water conservation or production safety, may be credited against tax payable.

Article 35 The detailed measures for the preferential tax treatments provided for in this Law shall be stipulated by the State Council.

Article 36 To meet the needs of national economic and social development, or in response to unexpected events that have substantial impacts on enterprises' business operations, the State Council may issue policies on special tax incentives and shall notify the Standing Committee of the National People's Congress of such policies.

CHAPTER 5 WITHHOLDING OF TAX AT SOURCE

Article 37 The income tax payable by a non-resident enterprise on the income as described in paragraph 3 of Article 3 of this Law shall be withheld at source, and the payer shall be the withholding agent. The withholding agent shall withhold the tax from the amount paid or payable at the time the amount is paid or becomes due.

Article 38 With respect to the income tax payable on the income derived by a nonresident enterprise from performance of engineering work and provision of labor services within China, the tax authorities may designate the payer of the contracted amount or service fee as the withholding agent.

Article 39 Should the withholding agent fail to withhold the income tax payable or be unable to perform its withholding obligation in respect of such income tax payable as specified in Article 37 and Article 38 of this Law, the taxpayer shall pay the tax at the place where such taxable income is derived. If the taxpayer fails to pay the tax as required by law, the tax authorities are empowered to recover the tax payable by the taxpayer from any other revenue due to the taxpayer from another payer in China.

Article 40 A withholding agent shall remit each amount of tax it withholds to the state treasury within seven days of the date of withholding and shall file withholding tax returns with the local tax authority at the place where it is located.

CHAPTER 6 SPECIAL TAX ADJUSTMENTS

Article 41 If a business transaction between an enterprise and a related party does not comply with the arm's-length principle, thus reducing the taxable income or revenue of the enterprise or the related party, the tax authorities shall be empowered to make adjustments using reasonable methods

When computing the taxable income, the costs incurred by an enterprise and a related party for the joint development or transfer of intangible assets, or for the joint provision or receipt of labor services, shall be allocated based on the arm's-length principle.

Article 42 An enterprise may submit the pricing principles and computational methods applied in its related-party transactions to the tax authority. Through negotiation and validation, the tax authority may conclude an advance pricing arrangement with the enterprise.

Article 43 When an enterprise files its annual Corporate Income Tax return with the tax authority, it shall submit, in respect of its business transactions with related parties, a form for the annual reporting of related-party transactions along with the annual Corporate Income Tax return.

When the tax authority conducts an investigation on related party transactions, the enterprise under investigation, its related parties, and other enterprises relevant to the related party transactions under investigation, shall provide relevant information according to the relevant rules.

Article 44 If an enterprise does not provide information on its related-party transactions, or provides false and incomplete information that does not truthfully reflect its related-party transactions, the tax authority shall be empowered to assess its taxable income on a deemed basis according to law.

Article 45 Where a resident enterprise by itself, or together with China individual residents, controls an enterprise that is established in a country (region) where the effective tax burden is distinctly lower than the tax rate set forth in paragraph 1 of Article 4 of this Law and that enterprise does not distribute its profits or reduces the distribution of its profits not on account of any reasonable operational needs, the portion of the profits attributable to the resident enterprise shall be included in the revenue of the resident enterprise in the current period.

Article 46 Where an enterprise receives from its related parties debt investment and equity investment in a ratio that exceeds the prescribed level, the interest expenses incurred as a result shall not be deductible in computing the taxable income of such enterprise.

Article 47 If an enterprise carries out any other business arrangements without reasonable business purposes resulting in reduction of its taxable revenue or income, the tax authority shall be empowered to make adjustments using reasonable methods.

Article 48 When additional tax is to be levied pursuant to a tax adjustment made by the tax authority in accordance with the provisions of this Chapter, the additional tax shall be collected and additional interest shall also be levied in accordance with the relevant stipulations by the State Council.

CHAPTER 7 TAX COLLECTION AND ADMINISTRATION

Article 49 The collection and administration of Corporate Income Tax shall be carried out in accordance with the provisions stipulated in this Law as well as Tax Collection and Administration Law of the People's Republic of China.

Article 50 Except as otherwise specified by tax laws and regulations, a resident enterprise shall pay tax at the place where it is registered, unless it is registered outside China, in which case it shall pay tax at the place of its effective management.

Where a resident enterprise has business establishments that do not have a legal person status in China, the Corporate Income Tax of such business establishments shall be calculated and paid on a consolidated basis.

Article 51 A non-resident enterprise shall pay tax at the place where its PRC establishment or place of business is located, if it derives income as described in paragraph 2 of Article 3 of this Law. If a non-resident enterprise has two or more establishments or places of business in China, it may, upon the approval of the tax authority, select its principal establishment or place of business to pay Corporate Income Tax on a consolidated basis.

A non-resident enterprise that derives income as described in paragraph 3 of Article 3 of this Law shall pay tax at the place where its withholding agent is located.

Article 52 Unless otherwise specified by the State Council, enterprises shall not be allowed to pay Corporate Income Tax on a consolidated basis.

Article 53 Corporate Income Tax shall be calculated for a tax year, which starts from January 1 and ends on December 31 of a calendar year.

If the actual operating period of an enterprise is less than 12 months in a tax year because it commences or terminates its business during the year, its actual operating period in the current year shall be treated as a tax year.

When an enterprise is liquidated according to law, the liquidation period shall be treated as a tax year.

Article 54 Corporate Income Tax shall be paid in advance on a monthly or quarterly basis.

An enterprise shall, within 15 days after the end of each month or quarter, file a Corporate Income Tax return with, and make the tax payment to, the tax authority.

Within five months of the year end, an enterprise shall file an annual Corporate Income Tax return with the tax authority, and perform the annual reconciliation so as to settle the tax to be paid or claim the tax to be refunded.

An enterprise shall file its financial and accounting reports and other relevant information along with the annual Corporate Income Tax return in accordance with the regulations.

Article 55 If an enterprise terminates its business operation in the middle of a tax year, it shall perform reconciliation and settle the annual Corporate Income Tax payment for the current period within 60 days of the date of the actual termination of its business operation.

Prior to deregistration with the tax authority, an enterprise shall file its Corporate Income Tax return with, and make the tax payment to, the tax authority on its liquidation income.

Article 56 Corporate Income Tax paid in accordance with this Law shall be calculated in RMB. Income earned in other currencies shall be converted into RMB for the purpose of computing and paying tax.

CHAPTER 8 SUPPLEMENTARY PROVISIONS

Article 57 According to the stipulations of the State Council, enterprises that have been approved to be established prior to the promulgation of this Law and that are entitled to reduced tax rates in accordance with the then prevailing tax laws and regulations, shall be eligible for a five-year transition period after the implementation of this Law in accordance with the stipulations of the State Council, during which time the tax rate will be increased step by step to the tax rate as set out in this Law; enterprises that are entitled to a fixed term tax exemption or reduction can continue to enjoy the incentive after the implementation of this Law until such term expires. However, for enterprises that have not started enjoying such tax incentive yet due to their losses, the tax incentive period shall be deemed to commence from the year when this Law comes into effect.

Transitional tax incentives shall be available to newly established Advanced and New Technology Enterprises that require the key support of the State provided that they are established in specially designated areas that have been set up in accordance with national laws with an aim to develop foreign economic cooperation and technological exchange, or are established in specific areas that have been permitted by the State Council to follow the special policies available in aforementioned areas. The State Council shall issue practical stipulations for such incentives.

The enterprises that have already been recognized by the State as other type of encouraged enterprises may enjoy tax exemptions or reductions in accordance with the stipulations of the State Council.

Article 58 Where the provisions of a tax treaty concluded between the government of the People's Republic of China and a foreign government are different from the provisions of this Law, the provisions of the treaty shall prevail.

Article 59 The State Council shall formulate implementation rules on the basis of this Law.

Article 60 This Law shall become effective on January 1, 2008. The Income Tax Law of the People's Republic of China on Foreign Investment Enterprises and Foreign Enterprises passed at the 4th Session of the 7th National People's Congress on April 9, 1991 and the Provisional Regulations of the People's Republic of China on Enterprise Income Tax promulgated by the State Council on December 13, 1993 shall be repealed on the same date.

Corporate Income Tax Law of the People’s Republic of China (Chinese version)

中华人民共和国企业所得税法

(2007年3月16日第十届全国人民代表大会第五次会议通过)

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第一章 总则

第一条 在中华人民共和国境内，企业和其他取得收入的组织（以下统称企业）为企业所得税的纳税人，依照本法的规定缴纳企业所得税。

个人独资企业、合伙企业不适用本法。

第二条 企业分为居民企业和非居民企业。

本法所称居民企业，是指依法在中国境内成立，或者依照外国（地区）法律成立但实际管理机构在中国境内的企业。

本法所称非居民企业，是指依照外国(地区)法律成立且实际管理机构不在中国境内，但在中国境内设立机构、场所的，或者在中国境内未设立机构、场所，但有来源于中国境内所得的企业。

第三条 居民企业应当就其来源于中国境内、境外的所得缴纳企业所得税。

非居民企业在中国境内设立机构、场所的，应当就其所设机构、场所取得的来源于中国境内的所得，以及发生在中国境外但与其所设机构、场所有实际联系的所得，缴纳企业所得税。

非居民企业在中国境内未设立机构、场所的，或者虽设立机构、场所但取得的所得与其所设机构、场所没有实际联系的，应当就其来源于中国境内的所得缴纳企业所得税。

第四条 企业所得税的税率为25%。

非居民企业取得本法第三条第三款规定的所得，适用税率为20%。

第二章 应纳税所得额

第五条 企业每一纳税年度的收入总额，减除不征税收入、免税收入、各项扣除以及允许弥补的以前年度亏损后的余额，为应纳税所得额。

第六条 企业以货币形式和非货币形式从各种来源取得的收入，为收入总额。包括：

(一)销售货物收入；
(二)提供劳务收入；
(三)转让财产收入；
(四)股息、红利等权益性投资收益；
(五)利息收入；
(六)租金收入；
(七)特许权使用费收入；
(八)接受捐赠收入；
(九)其他收入。

第七条 收入总额中的下列收入为不征税收入：

(一)财政拨款；
(二)依法收取并纳入财政管理的行政事业性收费、政府性基金；
(三)国务院规定的其他不征税收入。

第八条 企业实际发生的与取得收入有关的、合理的支出，包括成本、费用、税金、损失和其他支出，准予在计算应纳税所得额时扣除。

第九条 企业发生的公益性捐赠支出，在年度利润总额12%以内的部分，准予在计算应纳税所得额时扣除。

第十条 在计算应纳税所得额时，下列支出不得扣除：

(一)向投资者支付的股息、红利等权益性投资收益款项；
(二)企业所得税税款；
(三)税收滞纳金；
(四)罚金、罚款和被没收财物的损失；
(五)本法第九条规定以外的捐赠支出；
(六)赞助支出；

（七）未经核定的准备金支出；

（八）与取得收入无关的其他支出。

第十一条 在计算应纳税所得额时，企业按照规定计算的固定资产折旧，准予扣除。

下列固定资产不得计算折旧扣除：

（一）房屋、建筑物以外未投入使用的固定资产；

（二）以经营租赁方式租入的固定资产；

（三）以融资租赁方式租出的固定资产；

（四）已足额提取折旧仍继续使用的固定资产；

（五）与经营活动无关的固定资产；

（六）单独估价作为固定资产入账的土地；

（七）其他不得计算折旧扣除的固定资产。

第十二条 在计算应纳税所得额时，企业按照规定计算的无形资产摊销费用，准予扣除。

下列无形资产不得计算摊销费用扣除：

（一）自行开发的支出已在计算应纳税所得额时扣除的无形资产；

（二）自创商誉；

（三）与经营活动无关的无形资产；

（四）其他不得计算摊销费用扣除的无形资产。

第十三条 在计算应纳税所得额时，企业发生的下列支出作为长期待摊费用，按照规定摊销的，准予扣除：

（一）已足额提取折旧的固定资产的改建支出；

（二）租入固定资产的改建支出；

（三）固定资产的大修理支出；

（四）其他应当作为长期待摊费用的支出。

第十四条 企业对外投资期间，投资资产的成本在计算应纳税所得额时不得扣除。

第十五条 企业使用或者销售存货，按照规定计算的存货成本，准予在计算应纳税所得额时扣除。

第十六条 企业转让资产，该项资产的净值，准予在计算应纳税所得额时扣除。

第十七条 企业在汇总计算缴纳企业所得税时，其境外营业机构的亏损不得抵减境内营业机构的盈利。

第十八条 企业纳税年度发生的亏损，准予向以后年度结转，用以后年度的所得弥补，但结转年限最长不得超过五年。

第十九条 非居民企业取得本法第三条第三款规定的所得，按照下列方法计算其应纳税所得额：

（一）股息、红利等权益性投资收益和利息、租金、特许权使用费所得，以收入全额为应纳税所得额；

（二）转让财产所得，以收入全额减除财产净值后的余额为应纳税所得额；

（三）其他所得，参照前两项规定的方法计算应纳税所得额。

第二十条 本章规定的收入、扣除的具体范围、标准和资产的税务处理的具体办法，由国务院财政、税务主管部门规定。

第二十一条 在计算应纳税所得额时，企业财务、会计处理办法与税收法律、行政法规的规定不一致的，应当依照税收法律、行政法规的规定计算。

第三章 应纳税额

第二十二条 企业的应纳税所得额乘以适用税率，减除依照本法关于税收优惠的规定减免和抵免的税额后的余额，为应纳税额。

第二十三条 企业取得的下列所得已在境外缴纳的所得税税额，可以从其当期应纳税额中抵免，抵免限额为该项所得依照本法规定计算的应纳税额；超过抵免限额的部分，可以在以后五个年度内，用每年度抵免限额抵免当年应抵税额后的余额进行抵补：

（一）居民企业来源于中国境外的应税所得；

（二）非居民企业在中国境内设立机构、场所，取得发生在中国境外但与该机构、场所有实际联系的应税所得。

第二十四条 居民企业从其直接或者间接控制的外国企业分得的来源于中国境外的股息、红利等权益性投资收益，外国企业在境外实际缴纳的所得税税额中属于该项所得负担的部分，可以作为该居民企业的可抵免境外所得税税额，在本法第二十三条规定的抵免限额内抵免。

第四章 税收优惠

第二十五条 国家对重点扶持和鼓励发展的产业和项目，给予企业所得税优惠。

第二十六条 企业的下列收入为免税收入：

（一）国债利息收入；

（二）符合条件的居民企业之间的股息、红利等权益性投资收益；

（三）在中国境内设立机构、场所的非居民企业从居民企业取得与该机构、场所有实际联系的股息、红利等权益性投资收益；

（四）符合条件的非营利组织的收入。

第二十七条 企业的下列所得，可以免征、减征企业所得税：

（一）从事农、林、牧、渔业项目的所得；

（二）从事国家重点扶持的公共基础设施项目投资经营的所得；

（三）从事符合条件的环境保护、节能节水项目的所得；

（四）符合条件的技术转让所得；

（五）本法第三条第三款规定的所得。

第二十八条 符合条件的小型微利企业，减按20%的税率征收企业所得税。

国家需要重点扶持的高新技术企业，减按15%的税率征收企业所得税。

第二十九条 民族自治地方的自治机关对本民族自治地方的企业应缴纳的企业所得税中属于地方分享的部分，可以决定减征或者免征。自治州、自治县决定减征或者免征的，须报省、自治区、直辖市人民政府批准。

第三十条 企业的下列支出，可以在计算应纳税所得额时加计扣除：

（一）开发新技术、新产品、新工艺发生的研究开发费用；

（二）安置残疾人员及国家鼓励安置的其他就业人员所支付的工资。

第三十一条 创业投资企业从事国家需要重点扶持和鼓励的创业投资，可以按投资额的一定比例抵扣应纳税所得额。

第三十二条 企业的固定资产由于技术进步等原因，确需加速折旧的，可以缩短折旧年限或者采取加速折旧的方法。

第三十三条 企业综合利用资源，生产符合国家产业政策规定的产品所取得的收入，可以在计算应纳税所得额时减计收入。

第三十四条 企业购置用于环境保护、节能节水、安全生产等专用设备的投资额，可以按一定比例实行税额抵免。

第三十五条 本法规定的税收优惠的具体办法，由国务院规定。

第三十六条 根据国民经济和社会发展的需要，或者由于突发事件等原因对企业经营活动产生重大影响的，国务院可以制定企业所得税专项优惠政策，报全国人民代表大会常务委员会备案。

第五章 源泉扣缴

第三十七条 对非居民企业取得本法第三条第三款规定的所得应缴纳的所得税，实行源泉扣缴，以支付人为扣缴义务人。税款由扣缴义务人在每次支付或者到期应支付时，从支付或者到期应支付的款项中扣缴。

第三十八条 对非居民企业在中国境内取得工程作业和劳务所得应缴纳的所得税，税务机关可以指定工程价款或者劳务费的支付人为扣缴义务人。

第三十九条 依照本法第三十七条、第三十八条规定应当扣缴的所得税，扣缴义务人未依法扣缴或者无法履行扣缴义务的，由纳税人在所得发生地缴纳。纳税人未依法缴纳的，税务机关可以从该纳税人在中国境内其他收入项目的支付人应付的款项中，追缴该纳税人的应纳税款。

第四十条 扣缴义务人每次代扣的税款，应当自代扣之日起七日内缴入国库，并向所在地的税务机关报送扣缴企业所得税报告表。

第六章 特别纳税调整

第四十一条 企业与其关联方之间的业务往来，不符合独立交易原则而减少企业或者其关联方应纳税收入或者所得额的，税务机关有权按照合理方法调整。

企业与其关联方共同开发、受让无形资产，或者共同提供、接受劳务发生的成本，在计算应纳税所得额时应当按照独立交易原则进行分摊。

第四十二条 企业可以向税务机关提出与其关联方之间业务往来的定价原则和计算方法，税务机关与企业协商、确认后，达成预约定价安排。

第四十三条 企业向税务机关报送年度企业所得税纳税申报表时，应当就其与关联方之间的业务往来，附送年度关联业务往来报告表。

税务机关在进行关联业务调查时，企业及其关联方，以及与关联业务调查有关的其他企业，应当按照规定提供相关资料。

第四十四条 企业不提供与其关联方之间业务往来资料，或者提供虚假、不完整资料，未能真实反映其关联业务往来情况的，税务机关有权依法核定其应纳税所得额。

第四十五条 由居民企业，或者由居民企业和中国居民控制的设立在实际税负明显低于本法第四条第一款规定税率水平的国家（地区）的企业，并非由于合理的经营需要而对利润不作分配或者减少分配的，上述利润中应归属于该居民企业的部分，应当计入该居民企业的当期收入。

第四十六条 企业从其关联方接受的债权性投资与权益性投资的比例超过规定标准而发生的利息支出，不得在计算应纳税所得额时扣除。

第四十七条 企业实施其他不具有合理商业目的的安排而减少其应纳税收入或者所得额的，税务机关有权按照合理方法调整。

第四十八条 税务机关依照本章规定作出纳税调整，需要补征税款的，应当补征税款，并按照国务院规定加收利息。

第七章 征收管理

第四十九条 企业所得税的征收管理除本法规定外,依照《中华人民共和国税收征收管理法》的规定执行。

第五十条 除税收法律、行政法规另有规定外,居民企业以企业登记注册地为纳税地点;但登记注册地在境外的,以实际管理机构所在地为纳税地点。

居民企业在中国境内设立不具有法人资格的营业机构的,应当汇总计算并缴纳企业所得税。

第五十一条 非居民企业取得本法第三条第二款规定的所得,以机构、场所所在地为纳税地点。非居民企业在中国境内设立两个或者两个以上机构、场所的,经税务机关审核批准,可以选择由其主要机构、场所汇总缴纳企业所得税。

非居民企业取得本法第三条第三款规定的所得,以扣缴义务人所在地为纳税地点。

第五十二条 除国务院另有规定外,企业之间不得合并缴纳企业所得税。

第五十三条 企业所得税按纳税年度计算。纳税年度自公历1月1日起至12月31日止。

企业在一个纳税年度中间开业,或者终止经营活动,使该纳税年度的实际经营期不足十二个月的,应当以其实际经营期为一个纳税年度。

企业依法清算时,应当以清算期间作为一个纳税年度。

第五十四条 企业所得税分月或者分季预缴。

企业应当自月份或者季度终了之日起十五日内,向税务机关报送预缴企业所得税纳税申报表,预缴税款。

企业应当自年度终了之日起五个月内,向税务机关报送年度企业所得税纳税申报表,并汇算清缴,结清应缴应退税款。

企业在报送企业所得税纳税申报表时,应当按照规定附送财务会计报告和其他有关资料。

第五十五条 企业在年度中间终止经营活动的,应当自实际经营终止之日起六十日内,向税务机关办理当期企业所得税汇算清缴。

企业应当在办理注销登记前,就其清算所得向税务机关申报并依法缴纳企业所得税。

第五十六条 依照本法缴纳的企业所得税,以人民币计算。所得以人民币以外的货币计算的,应当折合成人民币计算并缴纳税款。

第八章 附则

第五十七条 本法公布前已经批准设立的企业,依照当时的税收法律、行政法规规定,享受低税率优惠的,按照国务院规定,可以在本法施行后五年内,逐步过渡到本法规定的税率;享受定期减免税优惠的,按照国务院规定,可以在本法施行后继续享受到期满为止,但因未获利而尚未享受优惠的,优惠期限从本法施行年度起计算。

法律设置的发展对外经济合作和技术交流的特定地区内,以及国务院已规定执行上述地区特殊政策的地区内新设立的国家需要重点扶持的高新技术企业,可以享受过渡性税收优惠,具体办法由国务院规定。

国家已确定的其他鼓励类企业,可以按照国务院规定享受减免税优惠。

第五十八条　中华人民共和国政府同外国政府订立的有关税收的协定与本法有不同规定的,依照协定的规定办理。

第五十九条 国务院根据本法制定实施条例。

第六十条　本法自2008年1月1日起施行。1991年4月9日第七届全国人民代表大会第四次会议通过的《中华人民共和国外商投资企业和外国企业所得税法》和1993年12月13日国务院发布的《中华人民共和国企业所得税暂行条例》同时废止。

APPENDIX 2

The Implementation Rules for the Corporate Income Tax Law of the People's Republic of China (unofficial English translation)

The Implementation Rules for the Corporate Income Tax Law of the People's Republic of China

(Passed at the 197th executive meeting of the State Council on November 28, 2007 and issued by Order of the State Council No. 512 on December 6, 2007)

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CHAPTER 1 GENERAL PROVISIONS

Article 1 These Implementation Rules are formulated in accordance with the Corporate Income Tax Law of the People's Republic of China (hereinafter referred to as the "Corporate Income Tax Law").

Article 2 "Sole proprietor enterprises" and "partnership enterprises" as mentioned in Article 1 of the Corporate Income Tax Law refers to sole proprietor enterprises and partnership enterprises that are established in accordance with the laws and administrative regulations of China.

Article 3 "An enterprise that is established in accordance with the laws of China" as mentioned in Article 2 of the Corporate Income Tax Law includes enterprises, public institutions, social organizations and other revenue-generating organizations that are established in China in accordance with the laws and administrative regulations of China.

"An enterprise that is established in accordance with the laws of foreign countries (regions)" as mentioned in Article 2 of the Corporate Income Tax Law includes enterprises and other revenue-generating organizations that are established in accordance with the laws of foreign countries (regions).

Article 4 A "place of effective management" as mentioned in Article 2 of the Corporate Income Tax Law refers to an establishment that exercises substantive and overall management and control over the production and business operations, personnel, financial functions, properties, etc. of an enterprise.

Article 5 "An establishment or place of business" as mentioned in paragraph 3 of Article 2 of the Corporate Income Tax Law refers to an establishment or place of business that is engaged in production and business operations in China, including:

(1) A management establishment, a business establishment or an office;
(2) A factory, farm, or place of extraction of natural resources;
(3) A place where services are provided;
(4) A place where a project of construction, installation, assembly, repair, exploration, etc. is carried out; and
(5) Other establishments or places of business where production and business operations are carried out.

Where a non-resident enterprise commissions a business agent to carry out in the territory of China production and business operations, including where the commissioned entity or individual habitually enters into contracts, or stores and delivers goods, etc. on its behalf, that business agent shall be regarded as an establishment or place of business of the non-resident enterprise in China.

Article 6 "Income" as mentioned in Article 3 of the Corporate Income Tax Law includes income from the sales of goods, income from the provision of services, income from the transfer of properties, dividends, profit distributions and other returns on equity investments, interest income, rental income, royalty income, income from donations and other income.

Article 7 "Income from sources within and outside China" as mentioned in Article 3 of the Corporate Income Tax Law shall be determined according to the following principles:

(1) For income from the sales of goods, the source shall be the place where the transactions take place;

(2) For income from the provision of services, the source shall be the place where the services are provided;
(3) For income from the transfer of properties, in the case of immovable properties, the source shall be the place where the property is located; in the case of movable properties, the source shall be where the enterprise, establishment or place of business that transfers the property is located; and in the case of equity investments, the source shall be where the invested enterprise is located;
(4) For income from dividends, profit distributions and other returns on equity investments, the source shall be the place where the enterprise making the distributions is located;
(5) For interest income, rental income, royalty income, the source shall be the place where the enterprise, establishment or place of business that bears or pays the income is located; or the place of residence of the individual who bears or pays the income; and
(6) For other income, the source shall be determined by the departments of the State Council in charge of finance and taxation.

Article 8 "Effectively connected" as mentioned in Article 3 of the Corporate Income Tax Law refers to the situation where the establishment or place of business in China of a non-resident enterprise owns the equity interests or debt claims that give rise to income, and where such establishment or place of business owns, manages or controls the properties that give rise to the income.

CHAPTER 2 TAXABLE INCOME

Section 1 General rules

Article 9 The taxable income of an enterprise shall be determined on an accrual basis. Income and expenses that are related to the current period shall be recognized as income and expenses for the current period regardless of whether the payments have been received or made; income and expenses that are not related to the current period shall not be recognized as income and expenses for the current period even if the payments have been received or made during the current period. Notwithstanding the above, these Implementation Rules and the departments of the State Council in charge of finance and taxation may prescribe otherwise.
Article 10 "Losses" as mentioned in Article 5 of the Corporate Income Tax Law refers to the negative amount that is arrived at by deducting non-taxable income, tax-exempt income and various deductions from the total income of each tax year in accordance with the provisions of the Corporate Income Tax Law and these Implementation Rules.
Article 11 "Liquidation income" as mentioned in Article 55 of the Corporate Income Tax Law refers to the balance of the realizable value of, or the transaction price for, all the assets of an enterprise after subtracting therefrom the net asset value, liquidation expenses and related taxes and charges.

Of the remaining assets that are distributed by the liquidating enterprise to the investing enterprise, the part that corresponds to the investing enterprise's share of the accumulated undistributed earnings and accumulated surplus reserves of the liquidating enterprise shall be treated as dividend income; the part of the remaining assets in excess of the aforementioned dividend income shall be recognized as gains or losses from the transfer of investment assets to the extent that such part is in excess of or less than the cost of investment.

Section 2 Income

Article 12 "Monetary revenue derived by an enterprise" as mentioned in Article 6 of the Corporate Income Tax Law includes cash, deposits, accounts receivable, notes receivable, bond investments to be held to maturity, debts forgiven, etc.

"Non-monetary revenue derived by an enterprise" as mentioned in Article 6 of the Corporate Income Tax Law includes fixed assets, biological assets, intangible assets, equity investments, inventories, bond investments not to be held to maturity, services and related rights and benefits, etc.

Article 13 "Non-monetary revenue derived by an enterprise" as mentioned in Article 6 of the Corporate Income Tax Law shall be determined based on the fair value.

The aforementioned fair value refers to the value that is determined in accordance with the market price.

Article 14 "Revenue from the sale of goods" as mentioned in item (1) of Article 6 of the Corporate Income Tax Law refers to the income derived by an enterprise from the sale of merchandise, products, raw materials, packaging materials, low-value consumables and other inventories.

Article 15 "Revenue from the provision of services" as mentioned in item (2) of Article 6 of the Corporate Income Tax Law refers to the revenue derived by an enterprise from engaging in construction and installation, repair, transportation, warehousing and letting, finance and insurance, postal communications and telecommunications, consultancy and brokerage, culture and sports, scientific research, technical services, education and training, catering and accommodation, intermediary and agency, sanitation and health care, community services, tourism, entertainment, processing and other service activities.

Article 16 "Revenue from the transfer of property" as mentioned in item (3) of Article 6 of the Corporate Income Tax Law refers to the revenue derived by an enterprise from the transfer of fixed assets, biological assets, intangible assets, equity interests, debt claims, etc.

Article 17 "Dividends, profit distributions and other returns on equity investments" as mentioned in item (4) of Article 6 of the Corporate Income Tax Law refers to income derived by an enterprise from investees on account of equity investments.

Dividends, profit distributions and other returns on equity investments shall be recognized on the date on which the investee resolves to make a profit distribution, unless the departments of the State Council in charge of finance and taxation prescribe otherwise.

Article 18 "Interest income" as mentioned in item (5) of Article 6 of the Corporate Income Tax Law refers to revenue derived by an enterprise from the provision of funds for the use by others that does not constitute an equity investment, or from the use of its funds by others, including deposit interest, loan interest, bond interest, arrears interest, etc.

Interest income shall be recognized on the date on which the interest becomes payable by the debtor under the contract.

Article 19 "Rental income" as mentioned in item (6) of Article 6 of the Corporate Income Tax Law refers to the revenue derived by an enterprise from the provision of the right to use fixed assets, packaging device or other tangible assets.

Rental income shall be recognized on the date on which the rent becomes payable under the contract.

Article 20 "Royalty income" as mentioned in item (7) of Article 6 of the Corporate Income Tax Law refers to revenue derived by an enterprise from the provision of the right to use patents, non-patented technologies, trademarks, copyrights and other licensed rights.

Royalties shall be recognized on the date on which the royalties become payable under the contract.

Article 21 "Donation income" as mentioned in item (8) of Article 6 of the Corporate Income Tax Law refers to monetary and non-monetary assets received by an enterprise from other enterprises, organizations or individuals without consideration.

Donations income shall be recognized as revenue on the date on which the donated assets are actually received.

Article 22 "Other revenue" as mentioned in item (9) of Article 6 of the Corporate Income Tax Law refers to income derived by an enterprise other than those prescribed under items (1) to (8) of Article 6 of the Corporate Income Tax Law, including revenue from asset surpluses, deposits on packaging devices which are overdue for return, accounts payable that cannot be settled, recoveries on accounts receivable that have been written off as bad debts, revenue from debt restructuring, subsidies, compensations for the breach of contracts, exchange gains, etc.

Article 23 Revenue from the following production and business operations may be recognized on an installment basis:

(1) Where the sale of goods is on an installment basis, revenue shall be recognized on the date on which the payments become due under the contracts;

(2) Where enterprises are engaged, under contract, to process or manufacture large-scale machinery and equipment, vessels, aircraft, and to carry out construction, installation, assembly projects or to provide other services, the duration of which exceeds 12 months, revenue shall be recognized based upon the rate of progress or the amount of work completed within the tax year.

Article 24 Where revenue is derived under production sharing, revenue shall be recognized on the date on which the products are distributed to the participating enterprises, and the amount of revenue shall be determined based upon the fair value of the products.

Article 25 Unless otherwise provided by the departments of the State Council in charge of finance and taxation, the exchange of non-monetary assets by enterprises, and the use of goods, assets or services for donations, debt settlement, sponsorship, fund raising, advertisement, samples, staff welfare or profit distributions shall be deemed as a sale of goods, transfer of assets or provision of services.

Article 26 "Fiscal appropriation" as mentioned in item (1) of Article 7 of the Corporate Income Tax Law refers to fund allocated by the People's Government at various levels for public institutions, social organizations, etc. that are under the budgetary administration of the government, unless otherwise provided by the State Council or the departments of the State Council in charge of finance and taxation.

"Government administrative charges" as mentioned in item (2) of Article 7 of the Corporate Income Tax Law refers to charges that are collected from specific subjects and are placed under government's financial administration during the process of carrying out social public administration, and providing specific public services to citizens, legal persons or other organizations in

accordance with relevant laws and regulations, and as approved pursuant to the procedures prescribed by the State Council.

"Government funds" as mentioned in item (2) of Article 7 of the Corporate Income Tax Law refers to funds of a fiscal nature that are collected by enterprises on behalf of the Government for specific purposes in accordance with the relevant laws and administrative regulations.

"Other non-taxable revenue stipulated by the State Council" as mentioned in item (3) of Article 7 of the Corporate Income Tax Law refers to funds of a fiscal nature received by enterprises, which are to be used for specific purposes as designated by the departments of the State Council in charge of finance and taxation and are approved by the State Council.

Section 3 Deductions

Article 27 "Related expenses" as mentioned in Article 8 of the Corporate Income Tax Law refers to expenses that are directly related to the generation of revenue.

"Reasonable expenses" as mentioned in Article 8 of the Corporate Income Tax Law refers to necessary and normal expenses that are incurred in the ordinary course of production and business operations and that should be taken into account in determining the profits or losses, or the costs of the related assets, during the current period.

Article 28 Expenditures incurred by an enterprise shall be classified into revenue expenditures and capital expenditures. Revenue expenditures shall be directly deducted in the period in which they are incurred; capital expenditures shall be deducted on a periodic basis or included in the cost of the related assets, instead of being directly deducted in the period in which they are incurred.

Expenses or assets, which arise out of the disbursement of non-taxable revenue of an enterprise, shall not be deducted, depreciated or amortized.

Unless the Corporate Income Tax Law and these Implementation Rules prescribe otherwise, costs, expenses, taxes, losses and other expenditures actually incurred by an enterprise shall not be deducted more than once.

Article 29 "Costs" as mentioned in Article 8 of the Corporate Income Tax Law refers to the cost of sales, cost of goods sold, business expenditures and other outlays incurred by an enterprise in the course of production and business operations.

Article 30 "Expenses" as mentioned in Article 8 of the Corporate Income Tax Law refers to selling expenses, administrative expenses and financial expenses incurred by an enterprise in the course of production and business operations, except for those that have been recorded as costs.

Article 31 "Taxes" as mentioned in Article 8 of the Corporate Income Tax Law refers to various taxes and surcharges incurred by an enterprise other than the Corporate Income Tax and creditable Value Added Tax.

Article 32 "Losses" as mentioned in Article 8 of the Corporate Income Tax Law refers to losses suffered as a result of the stock-taking loss, damage or scrapping of fixed assets and inventories, losses arising out of transfers of properties, doubtful debts, bad debts, or natural disasters and similar force majeure, or other losses that are incurred by an enterprise in the course of production and business operations.

Losses incurred by an enterprise, after deducting the compensation from responsible persons and insurance proceeds, may be deducted in accordance with regulations prescribed by the departments of the State Council in charge of finance and taxation.

Assets that have been written off as losses shall, upon recovery in whole or in part in a subsequent tax year, be recognized as revenue in that year.

Article 33 "Other expenses" as mentioned in Article 8 of the Corporate Income Tax Law refers to reasonable expenses, which are incurred by an enterprise in the course of its production and business operations, other than costs, expenses, taxes and losses.

Article 34 Reasonable salary and wage expenses incurred by an enterprise shall be deductible.

"Salary and wage expenses" as mentioned in the previous paragraph refers to all cash and non-cash remunerations that are paid by an enterprise to the employees who are appointed or employed by the enterprise during each tax year, including basic wages, bonuses, allowances, subsidies, year-end extra salaries, overtime wages, and other expenditures in connection with the appointment or employment of employees.

Article 35 Basic pension premiums, basic medical insurance premiums, unemployment insurance premiums, work injury insurance premiums, maternity insurance premiums and similar basic social insurance premiums, as well as housing funds contributions, that are paid by an enterprise for its employees in accordance with the scope and standards prescribed by the departments of the State Council in charge of finance and taxation or the provincial People's Governments shall be deductible.

Supplemental pension premiums and supplemental medical insurance premiums that are paid by an enterprise for its investors or employees in accordance with the scope and standards prescribed by the departments of the State Council in charge of finance and taxation shall be deductible.

Article 36 Except for personal safety insurance premiums paid by an enterprise for employees of special job categories in accordance with relevant government regulations and other commercial insurance premiums that are allowed as deductions by the departments of the State Council in charge of finance and taxation, commercial insurance premiums that are paid by an enterprise for its investors or employees shall not be deductible.

Article 37 Reasonable borrowing expenses that are incurred by an enterprise in the course of production and business operations and that are not required to be capitalized shall be deductible.

Where an enterprise borrows funds in the course of acquiring and constructing fixed assets, intangible assets, and inventories whose construction takes at least 12 months to reach the expected saleable condition, reasonable borrowing expenses that are incurred during the period of relevant acquisitions and constructions shall be capitalized as costs of the relevant assets and deducted in accordance with the provisions of these Implementation Rules.

Article 38 The following interest expenses incurred by an enterprise in the course of production and business operations shall be deductible:

(1) Interest expenses incurred by non-financial institutions on loans from financial institutions, interest expenses incurred by financial institutions on various deposits and on inter-bank borrowings, interest expenses incurred by enterprises on bonds approved for issuance;

(2) Interest expenses incurred by non-financial institutions on loans from non-financial institutions to the extent that they do not exceed the amounts calculated by reference to the interest rates applicable to loans of the same period and category made by financial institutions.

Article 39 Foreign exchange losses that are incurred by an enterprise in currency transactions, and foreign exchange losses that arise at the end of a tax year as a result of a conversion of non-RMB denominated monetary assets and liabilities to RMB at the year-end medium spot exchange rate shall be deductible, except for the portion that has been recorded as the cost of assets or that is related to profit distributions to the shareholders.
Article 40 Staff welfare expenses incurred by an enterprise, to the extent not exceeding 14% of the total salaries and wages, shall be deductible.
Article 41 Labor union funds contributed by an enterprise, to the extent not exceeding 2% of the total salaries and wages, shall be deductible.
Article 42 Unless otherwise provided by the departments of the State Council in charge of finance and taxation, staff education expenses that are incurred by an enterprise, to the extent not exceeding 2.5% of the total salaries and wages, shall be deductible; any excess amount may be carried forward and deducted in succeeding tax years.
Article 43 Entertainment expenses incurred by an enterprise in connection with production and business operations shall be deductible at 60% of the actual amount, but such deduction shall not exceed 0.5% of the sales (business) revenue of the year.
Article 44 Unless otherwise provided by the departments of the State Council in charge of finance and taxation, qualified advertising expenses and promotional expenses that are incurred by an enterprise shall be deductible to the extent not exceeding 15% of the sales (business) revenue of the year; any excess amount may be carried forward and deducted in succeeding tax years.
Article 45 Specific funds that are set aside by an enterprise for environmental protection, eco-regeneration and similar purposes in accordance with relevant laws and administrative regulations shall be deductible. The deduction shall be disallowed where the use of aforementioned specific funds has changed.
Article 46 Insurance premiums paid by an enterprise for the insurance of its properties in accordance with relevant regulations shall be deductible.
Article 47 Leasing expenses that are incurred by an enterprise on the lease of fixed assets that are required for production and business operations shall be deducted under the following methods:

(1) Leasing expenses that are incurred on the lease of fixed assets under operating leases shall be deducted evenly over the term of the lease;
(2) Where leasing expenses are incurred on the lease of fixed assets under finance leases, the part of such expenses that constitutes the value of the fixed assets under finance leases in accordance with relevant regulations shall be depreciated and deducted periodically.

Article 48 Reasonable labor protection expenses incurred by an enterprise shall be deductible.
Article 49 Management fees paid between enterprises, rentals and royalties paid between business establishments within an enterprise and interest paid between business establishments within a non-bank enterprise shall not be deductible.
Article 50 For establishments and places of business that are established by nonresident enterprises in China, expenses that are incurred by their head offices outside China in connection with the production and business operations of such establishments and places of business shall be deductible, provided that such expenses can be substantiated by documentation from the head

offices certifying the scope of the expenses to be allocated, the amounts involved, the basis and methodologies of allocation, etc. and that such allocation is reasonable.

Article 51 "Donations made by an enterprise for public welfare" as mentioned in Article 9 of the Corporate Income Tax Law refers to donations that are made by enterprises through social organizations serving public welfare or People's Governments at the county above level and their departments and that are used for public welfare undertakings prescribed by the Welfare Donations Law of the People's Republic of China.

Article 52 "Social organizations serving public welfare" as mentioned in Article 51 of these Implementation Rules refers to a foundation, a charitable organization or a similar social organization that meets the following criteria:

(1) It is legally registered with a legal person status;
(2) Its mission is to pursue public welfare undertakings, and its objective is not to make profits;
(3) All assets and their appreciation are owned by the legal person;
(4) Earnings and operating surplus are used primarily in undertakings that are consistent with the goals of the legal person;
(5) Upon termination, the remaining assets do not belong to any individuals or for-profit organizations;
(6) It does not engage in any business that is not relevant to its established goals;
(7) It has sound and comprehensive financial accounting systems;
(8) its donors do not participate in the distribution of the assets of the social organizations in any way or form; and
(9) It meets other criteria that the departments of the State Council in charge of finance and taxation may prescribe in conjunction with the civil affairs departments of the State Council and similar registration and administrative departments.

Article 53 Donations for public welfare that are made by an enterprise, to the extent not exceeding 12% of its total annual profit, shall be deductible. The "total profit for the year" refers to the accounting profit of an enterprise that is calculated based upon the rules of the uniform accounting system of China.

Article 54 "Sponsorship expenses" as mentioned in item (6) of Article 10 of the Corporate Income Tax Law refers to various expenses incurred by an enterprise that are not connected with the production and business operations and that are not in the nature of advertising expenses.

Article 55 "Unapproved provisions" as mentioned in item (7) of Article 10 of the Corporate Income Tax Law refers to various provisions for asset impairment, risk reserves, etc. that are not in compliance with the regulations prescribed by the departments of the State Council in charge of finance and taxation.

Section 4 Tax treatment of assets

Article 56 The tax base of an enterprise's assets, including fixed assets, biological assets, intangible assets, long-term deferred expenditures, investment assets, inventories, etc. shall be based on historical cost.

"Historical cost" as mentioned in the previous paragraph refers to expenditures that are actually incurred by an enterprise in acquiring the assets.

Where assets held by an enterprise appreciate or depreciate in value during the holding period, the tax base of such assets shall not be adjusted unless gains or losses are determined according to the regulations prescribed by the departments of the State Council in charge of finance and taxation.

Article 57 "Fixed assets" as mentioned in Article 11 of the Corporate Income Tax Law refers to non-monetary assets which are used for a period in excess of 12 months and which are held by an enterprise for the production of goods, the provision of services, leasing or operation and management, including buildings, structures, machinery, mechanical apparatus, means of transportation and other equipment, instruments, tools, etc. that are related to production and business operations.

Article 58 The tax base of fixed assets shall be determined according to the following methods:

(1) The tax base of purchased fixed assets shall be determined based upon the purchase price, related taxes and charges paid, other expenditures that are directly attributed to preparing the assets for their intended use;
(2) The tax base of self-constructed fixed assets shall be the expenditures that are incurred prior to the completion of such construction;
(3) The tax base of fixed assets under finance leases shall be the total lease payments under the lease contract and the related expenses that are incurred by the lessee in the course of entering into the lease contract. Where the total lease payments are not specified in the lease contract, the tax base of fixed assets under finance leases shall be the fair value of the assets and related expenses that are incurred by the lessee in the course of entering into the lease contract;
(4) The tax base of fixed assets inventory surplus shall be the total replacement value of fixed assets of the same category;
(5) The tax base of fixed assets that are acquired through donations, investment, exchange of non-monetary assets, debt restructuring, etc. shall be the fair value of such assets and related taxes and charges paid; and
(6) The tax base of the fixed assets that have been altered shall be the alteration costs that are incurred during the alteration, excluding expenses referred to in items (1) and (2) of Article 13 of the Corporate Income Tax Law.

Article 59 Depreciation expenses on fixed assets that are calculated using the straight-line method shall be deductible.

An enterprise shall commence the calculation of depreciation expenses for fixed assets in the month following the month during which the fixed asset is placed into use; where a fixed asset ceases to be used, the enterprise shall stop the calculation of depreciation expenses in the month following the month during which the fixed asset ceases to be used.

An enterprise shall reasonably determine the estimated residual value of fixed assets taking into account the nature and the use of the fixed assets. Once the residual value is determined, it shall not be changed.

Article 60 Unless otherwise prescribed by the departments of the State Council in charge of finance and taxation, the minimum periods for computing depreciation expenses for fixed assets shall be as follows:

(1) Buildings and structures–20 years;
(2) Aircraft, trains, vessels, machinery, mechanical apparatus and other production equipment–10 years;
(3) Instruments, tools, furniture, etc. that are connected with production and business operations–5 years;
(4) Means of transportation other than aircraft, trains, vessels–4 years;
(5) Electronic equipment–3 years.

Article 61 For an enterprise that is engaged in the extraction of petroleum, natural gas and similar mineral resources, the deduction method for expenses that are incurred prior to commercial production and the depletion and the depreciation methods for relevant fixed assets shall be separately prescribed by the departments of the State Council in charge of finance and taxation.
Article 62 The tax base for biological assets used for production shall be determined using the following methods:

(1) For purchased biological assets used for production, the tax base shall be the purchase price and related taxes and charges paid;
(2) For biological assets used for production that are acquired through donations, investment, exchange of non-monetary assets, debt restructuring, etc., the tax base shall be the fair value of the assets and related taxes and charges paid.

"Biological assets used for production" as mentioned in the previous paragraph refers to biological assets that are held by an enterprise for the production of agricultural products, the provision of services, leasing, etc., including economic forests, forests of charcoal and firewood, productive livestock, draft animals, etc.
Article 63 Depreciation expenses for biological assets used for production that are calculated using the straight-line method shall be deductible.

An enterprise shall commence the calculation of depreciation expenses for the biological assets used for production in the month following the month during which the biological assets used for production are put into use; where a biological asset used for production ceases to be used, the enterprise shall stop the calculation of depreciation expense for the biological asset used for production in the month following the month during which the biological asset used for production ceases to be used.

An enterprise shall reasonably determine the estimated residual value of biological assets used for production taking into account the nature and the use of the biological assets used for production. Once the residual value is determined, it shall not be changed.
Article 64 The minimum periods for computing depreciation expenses for biological assets used for production shall be as follows:

(1) Forestry biological assets used for production - 10 years;
(2) Livestock biological assets used for production - 3 years

Article 65 "Intangible assets" as mentioned in Article 12 of the Corporate Income Tax Law refers to incorporeal, non-monetary, long term assets that are held by an enterprise for the production of goods, provision of services, leasing or operation and management, including patents, trademarks, copyrights, land use rights, proprietary technologies, goodwill, etc.

Article 66 The tax base of intangible assets shall be determined using the following methods:

(1) The tax base of purchased intangible assets shall be the purchase price, related taxes and charges paid, and other expenditures that are directly attributed to preparing the assets for their intended use;
(2) The tax base of self-developed intangible assets shall be the expenses that are incurred by an enterprise during the period from when the intangible assets first meet the criteria for capitalizations to when the intangible assets reach the stage of their intended use; and
(3) The tax base of intangible assets that are acquired through donations, investments, exchanges of non-monetary assets, debt restructurings, etc. shall be the fair value of the assets and related taxes and charges paid.

Article 67 Amortization expenses for intangible assets that are calculated using the straight-line method shall be deductible.

Intangible assets shall be amortized over a period of not less than 10 years.

Intangible assets that are acquired through investments or acquisitions shall be amortized over their useful lives prescribed under relevant laws or contracts.

Expenditures that are incurred in acquiring goodwill shall be deductible upon the complete disposal or liquidation of the enterprise.

Article 68 "Expenses incurred for the alteration of fixed assets" as mentioned in items (1) and (2) of Article 13 refers to expenses that are incurred for structural alterations of buildings and structures, extension of their useful lives, etc.

Expenses that are prescribed in item (1) of Article 13 of the Corporate Income Tax Law shall be amortized over the estimated remaining useful life of the fixed assets; expenses that are prescribed in item (2) of Article 13 shall be amortized over the remaining lease term that is stipulated in the lease contract.

Where the useful lives of fixed assets that have been altered are extended, their depreciation periods shall be extended accordingly, unless items (1) and (2) of Article 13 of the Corporate Income Tax Law prescribe otherwise.

Article 69 "Expenses incurred for the overhaul of fixed assets" as mentioned in item (3) of Article 13 of the Corporate Income Tax Law refers to expenses that meet all of the following criteria:

(1) Repair expenses are more than 50% of the tax base at the time of the acquisition of the fixed assets; and
(2) The useful life of the fixed assets is extended by more than two years.

Expenses that are prescribed in item (3) of Article 13 of the Corporate Income Tax Law shall be amortized over the remaining useful life of the fixed assets.

Article 70 "Other expenses that shall be treated as long-term deferred expenses" as mentioned in item (4) of Article 13 of the Corporate Income Tax Law shall be amortized starting from the month following the month during which the expenditures are incurred, and shall be amortized over a period of not less than three years.

Article 71 "Investment assets" as mentioned in Article 14 of the Corporate Income Tax Law refers to assets that arise out of external equity investments and debt investments made by an enterprise.

The costs of investment assets shall be deductible when an enterprise transfers or disposes of investment assets.

The costs of investment assets shall be determined using the following methods:

(1) Where the investment assets are acquired with cash, the costs shall be the purchase price; and
(2) Where the investment assets are acquired with consideration other than cash, the costs shall be the fair value of the assets and the related taxes and charges paid.

Article 72 "Inventories" as mentioned in Article 15 of the Corporate Income Tax Law refers to products or merchandise that are held by an enterprise for sale, work in progress, materials, etc. that are consumed in the process of production or provision of services.

The costs of inventories shall be determined using the following methods:

(1) Where the inventories are acquired with cash, the costs shall be the purchase price and the related taxes and charges paid;
(2) Where the inventories are acquired with consideration other than cash, the costs shall be the fair value of the assets and the related taxes and charges paid; and
(3) For agricultural products that are derived from biological assets used for production, the costs shall be the materials costs, the labor costs, shared indirect costs and similar necessary expenditures that are incurred in the course of production or harvesting.

Article 73 Enterprises may select the first-in-first-out method, the weighted average method or the specific identification method as their inventory costing method for inventories that are used or sold by the enterprises. Once selected, the inventory costing method shall not be arbitrarily changed.

Article 74 "Net asset value" as mentioned in Article 16 of the Corporate Income Tax Law and "net property value" as mentioned in Article 19 refer to the remaining tax base of the assets or properties, after deducting the depreciation, depletion, amortization, provisions, etc. in accordance with relevant regulations.

Article 75 Unless otherwise prescribed by the departments of the State Council in charge of finance and taxation, an enterprise shall recognize, at the time when the transactions take place, the gains or losses that arise out of transfers of assets in the course of a reorganization. The tax base of the relevant assets shall be re-determined based upon the transaction prices.

CHAPTER 3 TAX PAYABLE

Article 76 The calculation formula for tax payable as prescribed in Article 22 of the Corporate Income Tax Law shall be:

Tax payable = Taxable income x applicable tax rate–Tax reduced/exempted–Tax credit

The tax reduced/exempted and tax credit in the formula refer to taxes otherwise payable that are reduced, exempted and credited in accordance with the preferential tax treatments prescribed by the Corporate Income Tax Law and the State Council.

Article 77 "Foreign income tax paid" as mentioned in Article 23 of the Corporate Income Tax Law refers to taxes in the nature of corporate income tax that are payable, and actually paid, on income derived from sources outside China in accordance with the foreign tax laws and related regulations.

Article 78 "Tax credit limit" as mentioned in Article 23 of the Corporate Income Tax Law refers to the tax payable on income derived from sources outside China in accordance with the Corporate Income Tax Law and these Implementation Rules. Unless otherwise prescribed by the departments of the State Council in charge of finance and taxation, such tax credit limit shall be calculated by country (region) and not by income category and the calculation formula is as follows:

Total tax payable on income Taxable income derived
derived from both within and from the particular
Tax Credit Limit = outside China as calculated in X *foreign country (region)*___
accordance with the Corporate Total taxable income derived
Income Tax Law and these from sources both within
Implementation Rules and outside China.

Article 79 "Five years" as mentioned in Article 23 of the Corporate Income Tax Law refers to the five successive tax years following the year in which the taxes in the nature of corporate income tax, which are paid outside China on income derived from sources outside China, exceeds the tax credit limit.

Article 80 "Directly controlled" mentioned in Article 24 of the Corporate Income Tax Law refers to the situation where a resident enterprise directly holds at least 20% of equity interest in a foreign enterprise.

"Indirectly controlled" mentioned in Article 24 of the Corporate Income Tax Law refers to the situation where a resident enterprise indirectly holds at least 20% of the equity interest in a foreign enterprise. Detailed measures for determining indirect control shall be separately formulated by the departments of the State Council in charge of finance and taxation.

Article 81 When an enterprise claims a credit against tax payable in accordance with Articles 23 and 24 of the Corporate Income Tax Law, it shall provide relevant tax payment certificates for the corresponding year issued by the foreign tax authorities.

CHAPTER 4 TAX INCENTIVES

Article 82 "Interest from state treasury debts" as mentioned in item (1) of Article 26 of the Corporate Income Tax Law refers to interest that is derived by an enterprise from the state treasury debts issued by the finance department of the State Council.

Article 83 "Qualified dividends, profit distributions and other returns on equity investments derived from a resident enterprise from another resident enterprise" as mentioned in item (2) of Article 26 of the Corporate Income Tax Law refers to the investment return derived by a resident enterprise from its direct investment in another resident enterprise. "Dividends, profit distributions and other returns on equity investments" as referred to in items (2) and (3) of Article 26 of the Corporate Income Tax Law shall not include the return on investment in publicly issued and traded shares of a resident enterprise that are held for less than 12 consecutive months.

Article 84 "Qualified non-profit organization" as mentioned in item (4) of Article 26 of the Corporate Income Tax Law refers to an organization that satisfies all of the following conditions:

(1) It has completed the registration procedures required for non-profit organizations in accordance with the laws;
(2) It is engaged in public welfare or non-profit operations;
(3) Income derived by the organization is entirely used for the public welfare or non profit undertakings that are prescribed upon registration or in the Articles of Association, except for related and reasonable expenses of the organization;
(4) Its properties and the income or gains derived as a result of the holding of such properties are not used for distributions;
(5) As authorized in its registration and stipulated in its Articles of Association, the remaining assets after deregistration of the organization are used for public welfare or non-profit purposes, or are re-donated through registration and administrative authorities to other organizations of the same nature and missions, and the same are announced to the general public;
(6) The donors do not reserve or enjoy any rights in the assets that are donated to the organization; and
(7) Salaries and welfare benefits of employees are limited by prescribed ratios and properties of the organization are not distributed in a disguised form.

The administrative measures for assessing the qualifications of a non-profit organization referred to in the preceding paragraph shall be formulated by the departments of the State Council in charge of finance and taxation in conjunction with other relevant departments of the State Council.

Article 85 "Revenue of a qualified non-profit organization" as mentioned in item (4) of Article 26 of the Corporate Income Tax Law shall not include any revenue that is derived from for-profit operations of the non-profit organization, unless otherwise prescribed by the departments of the State Council in charge of finance and taxation.

Article 86 The tax exemption and reduction, as prescribed in item (1) of Article 27 of the Corporate Income Tax Law, on income derived by an enterprise from projects in agriculture, forestry, animal husbandry and fishery refer to:

(1) Income derived by an enterprise engaging in the following projects shall be exempt from Corporate Income Tax:
   i The growing of vegetables, grains, tuber crops, oil plants, beans, cotton, hemps, sugar crops, fruits and nuts;
   ii The selection and cultivation of new agricultural species;
   iii The growing of Chinese medicinal herbs;
   iv The cultivation and growing of forests;
   v The rearing of livestock and poultry;
   vi The harvesting of forestry products;

vii vii Irrigation, preliminary processing of agricultural products, veterinary services, promotion of agricultural technologies, operation and maintenance of agricultural machineries and similar agricultural, forestry, animal husbandry, fishery services projects;
viii Ocean fishing.

(2) The Corporate Income Tax applicable to an enterprise engaging in the following projects shall be reduced by 50%:
i The growing of flowers, tea plants and other crops used for beverages and spices;
ii Sea and inland water aquaculture.

Enterprises engaging in any projects that are restricted and prohibited by the State shall not be entitled to the preferential Corporate Income Tax treatments under this Article.

Article 87 "Public infrastructure projects eligible for key support from the State" as mentioned in item (2) of Article 27 of the Corporate Income Tax Law refers to projects involving ports and wharfs, airports, railways, highways, urban public transportation, electric power, water supplies, etc. as prescribed in the Catalogue of Public Infrastructure Projects Eligible for Preferential Corporate Income Tax Treatment.

Income derived by an enterprise from the investment in, and the operation of, public infrastructure projects eligible for key support from the State as referred to in the previous paragraph shall be eligible for a tax exemption for the first year to the third year, and a 50% reduction in Corporate Income Tax for the fourth year to the sixth year, starting from the year in which the project first generates operating income.

Enterprises that are engaged, under contract, in the operation or construction of projects referred to in this Article, or are engaged in the construction of projects referred to in this Article for self-use, shall not be entitled to the preferential Corporate Income Tax treatment prescribed under this Article.

Article 88 "Qualified environmental protection and energy or water conservation projects" as mentioned in item (3) of Article 27 of the Corporate Income Tax Law includes public sewerage treatment, public refuse treatment, synergistic development and utilization of methane, technological innovation in energy conservation and emission reduction, sea water desalination and similar projects. The qualification criteria and the scope shall be formulated by the departments of the State Council in charge of finance and taxation in conjunction with relevant departments of the State Council, and shall be promulgated and implemented with the approval of the State Council.

Income derived by an enterprise from engaging in qualified environmental protection and energy or water conservation projects as prescribed in the previous paragraph shall be eligible for a tax exemption for the first year to the third year, and a 50% reduction in Corporate Income Tax for the fourth year to the sixth year, starting from the year in which the project first generates operating income.

Article 89 For a project that is eligible for a tax reduction or exemption under Articles 87 and 88 of these Implementation Rules, where the project is transferred during the period of such tax reduction or exemption, the transferee of such project shall become eligible, on the date of the transfer, for the preferential treatment during the remaining period of such tax reductions or exemption. Where the project is transferred after the period for the tax reduction or exemption

has expired, the transferee of such projects shall not enjoy the above tax reduction or exemption with respect to the same project.

Article 90 "Income derived from technology transfers that meet certain conditions is eligible for Corporate Income Tax reduction or exemption" as mentioned in item (4) of Article 27 of the Corporate Income Tax Law means that, within a tax year, the portion of income from technology transfer that does not exceed RMB 5 million shall be exempt from Corporate Income Tax; the portion of income that exceeds RMB 5 million shall enjoy a 50% reduction.

Article 91 Income referred to in item (5) of Article 27 of the Corporate Income Tax Law that is derived by a non-resident enterprise shall be subject to Corporate Income Tax at a reduced rate of 10%.

The following income shall be exempt from Corporate Income Tax:

(1) Interest income from loans made by a foreign government to China government;
(2) Interest income from loans with preferential terms made by international financial organizations to China government and resident enterprises;
(3) Other income approved by the State Council.

Article 92 "Small-scale enterprises with low profitability that meet certain conditions" as mentioned in paragraph 1 of Article 28 of the Corporate Income Tax Law refers to enterprises that are not engaged in industries restricted or prohibited by the State and that meet all of the following conditions:

(1) For industrial enterprises, the taxable income for the year shall not exceed RMB 300,000, total employees shall not exceed 100, and total assets shall not exceed RMB 30 million;
(2) For all other enterprises, the taxable income for the year shall not exceed RMB 300,000, total employees shall not exceed 80, and total assets shall not exceed RMB 10 million.

Article 93 "High-and-New Technology Enterprises eligible for key support from the State" as mentioned in paragraph 2 of Article 28 of the Corporate Income Tax Law refers to enterprises that own core proprietary intellectual property rights, and that meet all of the following conditions:

(1) Products (services) are within the scope prescribed in the High-and-New Technology Sectors Eligible for Key Support from the State;
(2) The proportion of research and development expenditures to sales revenue is not lower than a prescribed ratio;
(3) The proportion of the revenue derived from high and new technology products (services) to the total revenue of the enterprise is not lower than a prescribed ratio;
(4) The proportion of the number of research and development personnel to the number of all employees is not lower than a prescribed ratio; and
(5) Other conditions prescribed by the administrative measures for assessing the qualifications of advanced and new technology enterprises.

The High-and-New Technology Sectors Eligible for Key Support from the State and the Administrative Measures for the Recognition of High-and-New Technology Enterprises shall

be formulated by the departments of the State Council in charge of science and technology, finance and taxation in conjunction with relevant departments of the State Council, and shall be promulgated and implemented with the approval of the State Council.

Article 94 "Ethnic autonomous regions" as mentioned in Article 29 of the Corporate Income Tax Law refers to autonomous regions, prefectures and counties with regional ethnic autonomy in accordance with the Law of the People's Republic of China on Ethnic Regional Autonomy.

Enterprises in ethnic autonomous regions that are engaged in industries restricted or prohibited by the State shall not be eligible for Corporate Income Tax reduction or exemption.

Article 95 "Additional deductions on research and development expenses" as mentioned in item (1) of Article 30 of the Corporate Income Tax Law refers to the additional tax deduction in excess of the actual research and development expenses incurred for developing new technologies, new products and new technological processes. Such additional tax deduction for research and development expenses shall equal 50% of the amount actually incurred in the case where the research and development expenses are not required to be capitalized as intangible assets. Research and development expenses that are required to be capitalized as intangible assets shall be amortized based upon 150% of the capitalized amount.

Article 96 "Additional deductions on salary expenses paid to disabled personnel employed by the enterprise" as mentioned in item (2) of Article 30 of the Corporate Income Tax Law refers to the additional tax deduction of 100% of the actual amount of salaries paid to disabled personnel employed by the enterprise. The relevant rules of the Law of the People's Republic of China on Safeguard of Disabled Persons shall apply with respect to the determination of the qualifications of the disabled personnel.

Measures for additional deductions on salary expenses paid to "other personnel whose employment is encouraged by the State" as mentioned in item (2) of Article 30 of the Corporate Income Tax Law shall be separately prescribed by the State Council

Article 97 "Set off against its taxable income" as mentioned in Article 31 of the Corporate Income Tax Law means that where a venture capital enterprise has invested for at least two years, in the form of an equity investment, in a medium to small-sized high and new technology enterprise that has not been listed on a stock exchange, 70% of the amount so invested may be set off against its taxable income in the year in which the equity has been held for two years; any amount that is not set off in that year may be carried forward and set off against its taxable income in succeeding tax years.

Article 98 Fixed assets for which "the depreciation period may be shortened or an accelerated depreciation method may be adopted" as mentioned in Article 32 of the Corporate Income Tax Law includes:

(1) Fixed assets that are upgraded and replaced frequently due to advancement in technologies;
(2) Fixed assets that are exposed to constantly high level of vibration or corrosion.

For fixed assets to be depreciated over shortened depreciable periods, the minimum depreciable periods shall not be shorter than 60% of the depreciable periods prescribed in Article 60 of these Implementation Rules. For fixed assets to be depreciated using an accelerated depreciation method, either the double-declining-balance method or the sum of the years digits method shall be adopted.

Article 99 The reduction in revenue mentioned in Article 33 of the Corporate Income Tax Law means that when computing its taxable income, an enterprise may include in its gross income only 90% of the revenue derived from the use as its raw materials of the resources prescribed in Catalogue of Preferential Corporate Income Tax Treatments for Synergistic Utilization of Resources in the production of goods that are neither restricted nor prohibited by the State and that are in compliance with relevant State and industry standards.

The proportion of the amount of raw materials referred to in the previous paragraph to the amount of materials for the production of goods shall not be lower than the criteria prescribed in Catalogue of Preferential Corporate Income Tax Treatments for Synergistic Utilization of Resources.

Article 100 "Credit against tax payable" as mentioned in Article 34 of the Corporate Income Tax Law refers to 10% of the amount invested in specialized equipment that may be credited against the tax payable by the enterprise for the current year, where the enterprise purchases and actually uses specialized equipment in environmental protection, energy or water conservation, safe production, etc. as prescribed in Catalogue of Preferential Corporate Income Tax Treatments for Specialized Equipment in Environmental Protection, Catalogue of Preferential Corporate Income Tax Treatments for Specialized Equipment in Energy or Water Conservation and Catalogue of Preferential Corporate Income Tax Treatments for Specialized Equipment in Safe Production; any excess in such credit may be carried forward for five succeeding tax years.

An enterprise that is eligible for the preferential Corporate Income Tax treatment prescribed in the previous paragraph shall actually purchase and use the equipment prescribed in the previous paragraph. An enterprise that purchases the aforementioned specialized equipment and that transfers or leases the same within five years of the purchase shall no longer be eligible for the preferential Corporate Income Tax treatment, and shall repay the amount that has been credited against the Corporate Income Tax payable.

Article 101 The catalogues of preferential Corporate Income Tax treatments referred to in Articles 87, 99 and 100 of these Implementation Rules shall be formulated by the departments of the State Council in charge of finance and taxation in conjunction with relevant departments of the State Council, and shall be promulgated and implemented with the approval of the State Council.

Article 102 An enterprise that is concurrently engaged in projects that are eligible for different preferential Corporate Income Tax treatments shall separately account for income eligible for each preferential treatment, and shall reasonably allocate the relevant expenses incurred during the period. Where income is not so separately accounted for, it shall not be eligible for the preferential Corporate Income Tax treatment.

CHAPTER 5 WITHHOLDING OF TAX AT SOURCE

Article 103 Where a non-resident enterprise is subject to the withholding of tax at source in accordance with the Corporate Income Tax Law, the taxable income shall be calculated in accordance with Article 19 of the Corporate Income Tax Law.

"The entire amount of revenue" as mentioned in Article 19 of the Corporate Income Tax Law refers to the total consideration and other charges received by a nonresident enterprise from a payer.

Article 104 "Payer" as mentioned in Article 37 of the Corporate Income Tax Law refers to an entity or an individual who is directly liable to a non-resident enterprise for the payment of all relevant amounts in accordance with relevant laws and regulations or contracts.

Article 105 "Pay" as mentioned in Article 37 of the Corporate Income Tax Law includes paying by cash, by remittance, by account transfers, by transfers of rights of equal value and similar monetary and non-monetary payments.

"Amount payable" as mentioned in Article 37 of the Corporate Income Tax Law refers to the amount payable that should be accounted for by the payer on an accrual basis in relevant costs and expenses.

Article 106 Circumstances under which a withholding agent may be designated, as prescribed in Article 38 of the Corporate Income Tax Law, include:

(1) Where the work on a project or the provision of services is projected to last less than a tax year, and there is evidence of non-fulfillment of tax obligations;
(2) Where tax registration or temporary tax registration has not been completed, and an agent in China has not been appointed to fulfill tax obligations on its behalf; or
(3) Where the annual or quarterly Corporate Income Tax return has not been filed within the prescribed ti me limits.

The tax authorities above the county or above level shall designate the withholding agent prescribed in the previous paragraph, and shall at the same time notify the withholding agent of the calculation basis, the calculation methods, the withholding deadline and the withholding methods.

Article 107 "The place where such taxable income is derived" as mentioned in Article 39 of the Corporate Income Tax Law refers to the place where taxable income is derived, as determined under the principles prescribed in Article 7 of these Implementation Rules. Where there are multiple places in China where taxable income is derived, the taxpayer shall select one of the places that shall perform Corporate Income Tax filing and make Corporate Income Tax payments.

Article 108 "Other revenue due to the taxpayer in China" as mentioned in Article 39 of the Corporate Income Tax Law refers to revenue derived by the taxpayer from various other sources within China.

When attempting to collect from the taxpayer the overdue tax payable, the tax authorities shall notify the taxpayer of the reasons, amount, deadline and methods of collection.

CHAPTER 6 SPECIAL TAX ADJUSTMENTS

Article 109 "Related party" as mentioned in Article 41 of the Corporate Income Tax Law refers to an enterprise, an organization or an individual that has one of the following relationships with the enterprise:

(1) There is a direct or indirect controlling relationship in financing, business
(2) operations, purchases, sales, etc.;
(3) The parties are directly or indirectly controlled by the same third party;
(4) Other relationships in which the parties have mutual interest.

Article 110 "The arm's-length principle" as mentioned in Article 41 of the Corporate Income Tax Law refers to the principle of adopting fair market prices and business norms for transactions carried out between non-related parties.

Article 111 "Reasonable methods" as mentioned in Article 41 of the Corporate Income Tax Law include:

(1) Comparable uncontrolled price method (CUP): refers to the pricing method based on a price for identical or similar business transactions conducted between non-related enterprises;
(2) Resale price method (RPM): refers to the pricing method based on the resale price at which the goods purchased from related parties are sold to non-related parties minus the gross margin derived from identical or similar transactions;
(3) Cost plus method (CPLM): refers to the pricing method based on cost plus reasonable expenses and profit margin;
(4) Transactional net margin method (TNMM): refers to the method whereby the profit is based on the net profit level achieved from identical or similar business transactions conducted between non-related parties;
(5) Profit split method (PSM): refers to the method whereby the consolidated profit or loss of an enterprise and its related parties are split based on reasonable criteria;
(6) Other methods in compliance with the arm's-length principle.

Article 112 An enterprise may reach a cost sharing agreement with its related parties on the sharing of jointly incurred costs based on the arm's length principle in accordance with paragraph 2 of Article 41 of the Corporate Income Tax Law.

When costs are shared between an enterprise and its related parties, the principle of matching costs with expected benefits shall be followed. The required information as specified by the tax authorities shall be filed with the tax authorities within the prescribed period.

If an enterprise fails to comply with paragraphs 1 and 2 of this Article in the sharing of costs with its related parties, the costs allocated shall not be allowed to be deducted when computing the enterprise's taxable income.

Article 113 "Advance pricing arrangement" as mentioned in Article 42 of the Corporate Income Tax Law refers to an agreement reached between an enterprise and the tax authorities, after the enterprise submits its application and negotiates with the tax authorities based on the arm's-length principle, on the pricing principle and computation method applicable to its related party transactions for future years.

Article 114 "Relevant information" as mentioned in Article 43 of the Corporate Income Tax Law includes:

(1) contemporaneous documentation relating to the standards, computation method and other explanations, etc. used to determine the prices or charges of the related party transactions;
(2) information relating to the resale (or transfer) price or ultimate sale (or transfer) price of property, rights to use the property, services etc. involved in the related party transactions;
(3) information to be submitted by other enterprises relevant to the related party transaction investigation regarding product prices, pricing methods and profitability, etc. that are comparable to the enterprise under investigation; and

(4) other information relevant to the related party transactions.
(5) "Other enterprises relevant to the related party transactions under investigation" as mentioned in Article 43 of the Corporate Income Tax Law refers to enterprises whose business scope and operation model are similar to the enterprise under investigation.

Enterprises shall provide tax authorities with the standards, computation methods and relevant explanations adopted in determining the prices and expenses of related party transactions within the prescribed time. The related parties and other enterprises relevant to the investigation of the related party transactions shall provide information within the time period agreed upon with the tax authorities.

Article 115 The following methods may be adopted by the tax authorities when assessing an enterprise's taxable income on a deemed basis in accordance with Article 44 of the Corporate Income Tax Law:

(1) by reference to the profit level of identical or similar enterprises;
(2) based on the enterprises' cost plus reasonable expenses and profit;
(3) based on the reasonable proportion of the related party's group profit; and
(4) based on other reasonable methods.

Where an enterprise disagrees with the tax authorities regarding the amount of deemed taxable income, calculated using the methods prescribed in the previous paragraph, it shall provide relevant supporting evidence. Upon confirmation by the tax authorities, the deemed taxable income can then be adjusted.

Article 116 "China individual resident" as mentioned in Article 45 of the Corporate Income Tax Law refers to an individual who is liable for individual income tax in China on income derived from both within and outside China in accordance with the Individual Income Tax Law of the People's Republic of China.

Article 117 "Control" as mentioned in Article 45 of the Corporate Income Tax Law includes the following instances:

(1) Where resident enterprises or China residents individually hold, directly or indirectly, 10% or more in voting shares of a foreign enterprise, and collectively hold at least 50% in shares of the foreign enterprise;
(2) Where the shareholding percentages of resident enterprises, or resident enterprises jointly with China individual residents, do not reach the percentages prescribed in (1) above, but such resident enterprises, or resident enterprises jointly with China individual residents, have substantive control of the foreign enterprise in shareholdings, funding, operations, purchases and sales and similar aspects.

Article 118 "The effective tax burden distinctly lower than the tax rate set forth in paragraph 1 of Article 4 of the Corporate Income Tax Law" as mentioned in Article 45 of the Corporate Income Tax Law refers to a tax rate that is lower than 50% of the tax rate set forth in paragraph 1 of Article 4 of the Corporate Income Tax Law.

Article 119 "Debt investment" as mentioned in Article 46 of the Corporate Income Tax Law refers to financing that is directly or indirectly obtained by an enterprise from its related parties, and that is to be repaid in principal and interest or to be compensated in ways similar in nature to paying interest.

The debt investments that an enterprise indirectly obtains from related parties include the following:

(1) The debt investments offered by related parties through an unrelated third party;
(2) The debt investments provided by an unrelated third party that is guaranteed, with a joint liability, by a related party; or
(3) Other debt investments, having the substance as such, obtained indirectly from related parties.

"Equity investment" as mentioned in Article 46 of the Corporate Income Tax Law refers to investments received by an enterprise without the obligation to repay principal and interest, and through which investors possess ownership rights in the net assets of the enterprise.

"The prescribed level" as mentioned in Article 46 of the Corporate Income Tax Law shall be separately prescribed by the departments of the State Council in charge of finance and taxation.

Article 120 "Without reasonable business purposes" as mentioned in Article 47 of the Corporate Income Tax Law refers to having reducing, avoiding or deferring paying taxes as primary purposes.

Article 121 When tax authorities make special tax adjustments in accordance with tax laws and administrative regulations, there shall be imposed interest, on a daily basis, upon the underpaid taxes for the period from June 1 of the year following the taxable year to which the underpayment relates to the date when the underpaid taxes are paid.

The interest prescribed in the previous paragraph shall not be deducted when computing the taxable income.

Article 122 "Interest" as mentioned in Article 48 of the Corporate Income Tax Law shall be calculated based upon the RMB loan base rate published by the People's Bank of China in the tax year(s) to which the underpaid tax belongs for a loan of the same term as the period for which additional tax is payable, plus 5%.

Enterprises that provide relevant information as prescribed in Article 43 of the Corporate Income Tax Law and these Implementation Rules may calculate the interest using only the benchmark interest rate on RMB loans prescribed in the previous paragraph.

Article 123 Where transactions conducted between related parties do not conform to the arm's-length principle, or where enterprises enter into arrangements with no reasonable business purpose, the tax authorities shall have the right to make tax adjustments within 10 years of the year during which the transactions take place.

CHAPTER 7 TAX COLLECTION AND ADMINISTRATION

Article 124 "The place where an enterprise is registered" as mentioned in Article 50 of the Corporate Income Tax Law refers to the location of the enterprise that is registered in accordance with the relevant regulations of the State.

Article 125 Where an enterprise consolidates the calculation and settlement of its Corporate Income Tax liability, it shall compute its taxable income on a consolidated basis. The detailed measures shall be separately formulated by the departments of the State Council in charge of finance and taxation.

Article 126 "Principal establishment or place of business" as mentioned in Article 51 of the Corporate Income Tax Law shall meet both of the following conditions:

(1) It bears the responsibility for the supervision and management of the production and business operations at other establishments and places of business; and
(2) It keeps complete accounting records and vouchers, which accurately reflect the income, costs, expenses and profits and losses of each establishment or place of business.

Article 127 "Upon the approval by the tax authorities" as mentioned in Article 51 of the Corporate Income Tax Law refers to the examination and approval by the upper-level tax authority which supervises the tax authorities at the locations of the establishments or places of business.

Where, subsequent to obtaining the approval for tax consolidation, a nonresident enterprise undergoes an expansion, merger, relocation, closure of establishments or places of business, or a termination of the business operations of the establishments or places of business, the principal establishment or place of business that is charged with consolidated filing and settlement shall report in advance to the tax authorities of the location of such principal establishment or place of business. Where the choice of the principal establishment or place of business that is charged with consolidated filing and settlement is to be changed, the procedures prescribed in the previous paragraph shall apply.

Article 128 The tax authorities shall determine whether an enterprise makes provisional Corporate Income Tax payments on a monthly or a quarterly basis. Where an enterprise makes provisional Corporate Income Tax payments on a monthly or a quarterly basis in accordance with Article 54 of the Corporate Income Tax Law, the provisional Corporate Income Tax payments shall be determined based upon the actual profits for the month or the quarter. Where it is difficult for an enterprise to determine its provisional Corporate Income Tax payments based upon the actual profits for the month or the quarter, the provisional Corporate Income Tax payments shall be determined based upon the average monthly or quarterly profits for the immediate preceding year, or based upon other methods permitted by the tax authorities. Once a provisional payment method is determined, that method shall not be arbitrarily changed within the tax year.

Article 129 An enterprise, irrespective of its profits or losses in a tax year, shall file with tax authorities the provisional Corporate Income Tax returns, annual Corporate Income Tax return, financial accounting reports and other information that is required by the tax authorities within the time limits prescribed by Article 54 of the Corporate Income Tax Law.

Article 130 Where the income of an enterprise is calculated in a currency other than RMB, the taxable income shall be converted into RMB using the medium exchange rate on the last day of a month or a quarter for which the provisional Corporate Income Tax payments are made. When settling the annual payment after the end of the year, the provisional Corporate Income Tax payments that have been made shall not be converted and calculated again; only the income on which Corporate Income Tax has not been paid for the tax year shall be converted into RMB using the medium exchange rate on the last day of the year in computing taxable income.

Where, upon the tax authorities' examination, an enterprise is determined to have understated or overstated its income, the enterprise shall calculate the understated or overstated income in RMB using the medium exchange rate on the last day of the month immediately preceding the month during which the underpayment or overpayment of taxes is determined, and then calculate the amount of taxes to be paid additionally or refunded.

CHAPTER 8 SUPPLEMENTARY PROVISIONS

Article 131 "Enterprises that have been approved to be established prior to the promulgation of this Law" as mentioned in Article 57 of the Corporate Income Tax Law refers to enterprises that have completed the business registration prior to the promulgation of the Corporate Income Tax Law.

Article 132 Enterprises that are established in the Hong Kong Special Administrative Region, the Macao Special Administrative Region and Taiwan region shall apply the relevant provisions under paragraphs 2 and 3 of Article 2 of the Corporate Income Tax Law.

Article 133 These Implementation Rules shall take effect on January 1, 2008. The Detailed Implementation Rules of the Income Tax Law of the People's Republic of China on Foreign Investment Enterprises and Foreign Enterprises promulgated by the State Council on June 30, 1991 and the Detailed Implementation Rules for the Provisional Regulations of the People's Republic of China on Enterprise Income Tax promulgated by the Ministry of Finance on February 4, 1994 shall hereby be repealed.

The Implementation Rules for the Corporate Income Tax Law of the People's Republic of China (Chinese version)

中华人民共和国企业所得税法实施条例

（2007年11月28日国务院第197次常务会议通过，2007年12月6日国务院令第512号公布）

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第一章 总则

第一条 根据《中华人民共和国企业所得税法》（以下简称企业所得税法）的规定，制定本条例。

第二条 企业所得税法第一条所称个人独资企业、合伙企业，是指依照中国法律、行政法规成立的个人独资企业、合伙企业。

第三条 企业所得税法第二条所称依法在中国境内成立的企业，包括依照中国法律、行政法规在中国境内成立的企业、事业单位、社会团体以及其他取得收入的组织。

企业所得税法第二条所称依照外国（地区）法律成立的企业，包括依照外国（地区）法律成立的企业和其他取得收入的组织。

第四条 企业所得税法第二条所称实际管理机构，是指对企业的生产经营、人员、账务、财产等实施实质性全面管理和控制的机构。

第五条 企业所得税法第二条第三款所称机构、场所，是指在中国境内从事生产经营活动的机构、场所，包括：

（一）管理机构、营业机构、办事机构；

（二）工厂、农场、开采自然资源的场所；

（三）提供劳务的场所；

（四）从事建筑、安装、装配、修理、勘探等工程作业的场所；

（五）其他从事生产经营活动的机构、场所。

非居民企业委托营业代理人在中国境内从事生产经营活动的，包括委托单位或者个人经常代其签订合同，或者储存、交付货物等，该营业代理人视为非居民企业在中国境内设立的机构、场所。

第六条 企业所得税法第三条所称所得，包括销售货物所得、提供劳务所得、转让财产所得、股息红利等权益性投资所得、利息所得、租金所得、特许权使用费所得、接受捐赠所得和其他所得。

第七条 企业所得税法第三条所称来源于中国境内、境外的所得，按照以下原则确定：

（一）销售货物所得，按照交易活动发生地确定；

（二）提供劳务所得，按照劳务发生地确定；

（三）转让财产所得，不动产转让所得按照不动产所在地确定，动产转让所得按照转让动产的企业或者机构、场所所在地确定，权益性投资资产转让所得按照被投资企业所在地确定；

（四）股息、红利等权益性投资所得，按照分配所得的企业所在地确定；

（五）利息所得、租金所得、特许权使用费所得，按照负担、支付所得的企业或者机构、场所所在地确定，或者按照负担、支付所得的个人的住所地确定；

（六）其他所得，由国务院财政、税务主管部门确定。

第八条 企业所得税法第三条所称实际联系，是指非居民企业在中国境内设立的机构、场所拥有据以取得所得的股权、债权，以及拥有、管理、控制据以取得所得的财产等。

第二章 应纳税所得额

第一节 一般规定

第九条 企业应纳税所得额的计算，以权责发生制为原则，属于当期的收入和费用，不论款项是否收付，均作为当期的收入和费用；不属于当期的收入和费用，即使款项已经在当期收付，均不作为当期的收入和费用。本条例和国务院财政、税务主管部门另有规定的除外。

第十条 企业所得税法第五条所称亏损，是指企业依照企业所得税法和本条例的规定将每一纳税年度的收入总额减除不征税收入、免税收入和各项扣除后小于零的数额。

第十一条 企业所得税法第五十五条所称清算所得，是指企业的全部资产可变现价值或者交易价格减除资产净值、清算费用以及相关税费等后的余额。

投资方企业从被清算企业分得的剩余资产，其中相当于从被清算企业累计未分配利润和累计盈余公积中应当分得的部分，应当确认为股息所得；剩余资产减除上述股息所得后的余额，超过或者低于投资成本的部分，应当确认为投资资产转让所得或者损失。

第二节 收入

第十二条 企业所得税法第六条所称企业取得收入的货币形式，包括现金、存款、应收账款、应收票据、准备持有至到期的债券投资以及债务的豁免等。

企业所得税法第六条所称企业取得收入的非货币形式，包括固定资产、生物资产、无形资产、股权投资、存货、不准备持有至到期的债券投资、劳务以及有关权益等。

第十三条 企业所得税法第六条所称企业以非货币形式取得的收入，应当按照公允价值确定收入额。

前款所称公允价值，是指按照市场价格确定的价值。

第十四条 企业所得税法第六条第（一）项所称销售货物收入，是指企业销售商品、产品、原材料、包装物、低值易耗品以及其他存货取得的收入。

第十五条 企业所得税法第六条第（二）项所称提供劳务收入，是指企业从事建筑安装、修理修配、交通运输、仓储租赁、金融保险、邮电通信、咨询经纪、文化体育、科学研究、技术服务、教育培训、餐饮住宿、中介代理、卫生保健、社区服务、旅游、娱乐、加工以及其他劳务服务活动取得的收入。

第十六条 企业所得税法第六条第（三）项所称转让财产收入，是指企业转让固定资产、生物资产、无形资产、股权、债权等财产取得的收入。

第十七条 企业所得税法第六条第（四）项所称股息、红利等权益性投资收益，是指企业因权益性投资从被投资方取得的收入。

股息、红利等权益性投资收益，除国务院财政、税务主管部门另有规定外，按照被投资方作出利润分配决定的日期确认收入的实现。

第十八条 企业所得税法第六条第（五）项所称利息收入，是指企业将资金提供他人使用但不构成权益性投资，或者因他人占用本企业资金取得的收入，包括存款利息、贷款利息、债券利息、欠款利息等收入。

利息收入，按照合同约定的债务人应付利息的日期确认收入的实现。

第十九条 企业所得税法第六条第（六）项所称租金收入，是指企业提供固定资产、包装物或者其他有形资产的使用权取得的收入。

租金收入，按照合同约定的承租人应付租金的日期确认收入的实现。

第二十条 企业所得税法第六条第（七）项所称特许权使用费收入，是指企业提供专利权、非专利技术、商标权、著作权以及其他特许权的使用权取得的收入。

特许权使用费收入，按照合同约定的特许权使用人应付特许权使用费的日期确认收入的实现。

第二十一条 企业所得税法第六条第（八）项所称接受捐赠收入，是指企业接受的来自其他企业、组织或者个人无偿给予的货币性资产、非货币性资产。

接受捐赠收入，按照实际收到捐赠资产的日期确认收入的实现。

第二十二条 企业所得税法第六条第（九）项所称其他收入，是指企业取得的除企业所得税法第六条第（一）项至第（八）项规定的收入外的其他收入，包括企业资产溢余收入、逾期未退包装物押金收入、确实无法偿付的应付款项、已作坏账损失处理后又收回的应收款项、债务重组收入、补贴收入、违约金收入、汇兑收益等。

第二十三条 企业的下列生产经营业务可以分期确认收入的实现：

（一）以分期收款方式销售货物的，按照合同约定的收款日期确认收入的实现；

（二）企业受托加工制造大型机械设备、船舶、飞机，以及从事建筑、安装、装配工程业务或者提供其他劳务等，持续时间超过12个月的，按照纳税年度内完工进度或者完成的工作量确认收入的实现。

第二十四条 采取产品分成方式取得收入的，按照企业分得产品的日期确认收入的实现，其收入额按照产品的公允价值确定。

第二十五条 企业发生非货币性资产交换，以及将货物、财产、劳务用于捐赠、偿债、赞助、集资、广告、样品、职工福利或者利润分配等用途的，应当视同销售货物、转让财产或者提供劳务，但国务院财政、税务主管部门另有规定的除外。

第二十六条 企业所得税法第七条第（一）项所称财政拨款，是指各级人民政府对纳入预算管理的事业单位、社会团体等组织拨付的财政资金，但国务院和国务院财政、税务主管部门另有规定的除外。

企业所得税法第七条第（二）项所称行政事业性收费，是指依照法律法规等有关规定，按照国务院规定程序批准，在实施社会公共管理，以及在向公民、法人或者其他组织提供特定公共服务过程中，向特定对象收取并纳入财政管理的费用。

企业所得税法第七条第（二）项所称政府性基金，是指企业依照法律、行政法规等有关规定，代政府收取的具有专项用途的财政资金。

企业所得税法第七条第（三）项所称国务院规定的其他不征税收入，是指企业取得的，由国务院财政、税务主管部门规定专项用途并经国务院批准的财政性资金。

第三节 扣除

第二十七条 企业所得税法第八条所称有关的支出，是指与取得收入直接相关的支出。

企业所得税法第八条所称合理的支出，是指符合生产经营活动常规，应当计入当期损益或者有关资产成本的必要和正常的支出。

第二十八条 企业发生的支出应当区分收益性支出和资本性支出。收益性支出在发生当期直接扣除；资本性支出应当分期扣除或者计入有关资产成本，不得在发生当期直接扣除。

企业的不征税收入用于支出所形成的费用或者财产，不得扣除或者计算对应的折旧、摊销扣除。

除企业所得税法和本条例另有规定外，企业实际发生的成本、费用、税金、损失和其他支出，不得重复扣除。

第二十九条 企业所得税法第八条所称成本，是指企业在生产经营活动中发生的销售成本、销货成本、业务支出以及其他耗费。

第三十条 企业所得税法第八条所称费用，是指企业在生产经营活动中发生的销售费用、管理费用和财务费用，已经计入成本的有关费用除外。

第三十一条 企业所得税法第八条所称税金，是指企业发生的除企业所得税和允许抵扣的增值税以外的各项税金及其附加。

第三十二条 企业所得税法第八条所称损失，是指企业在生产经营活动中发生的固定资产和存货的盘亏、毁损、报废损失，转让财产损失，呆账损失，坏账损失，自然灾害等不可抗力因素造成的损失以及其他损失。

企业发生的损失，减除责任人赔偿和保险赔款后的余额，依照国务院财政、税务主管部门的规定扣除。

企业已经作为损失处理的资产，在以后纳税年度又全部收回或者部分收回时，应当计入当期收入。

第三十三条 企业所得税法第八条所称其他支出，是指除成本、费用、税金、损失外，企业在生产经营活动中发生的与生产经营活动有关的、合理的支出。

第三十四条 企业发生的合理的工资薪金支出，准予扣除。

前款所称工资薪金，是指企业每一纳税年度支付给在本企业任职或者受雇的员工的所有现金形式或者非现金形式的劳动报酬，包括基本工资、奖金、津贴、补贴、年终加薪、加班工资，以及与员工任职或者受雇有关的其他支出。

第三十五条 企业依照国务院有关主管部门或者省级人民政府规定的范围和标准为职工缴纳的基本养老保险费、基本医疗保险费、失业保险费、工伤保险费、生育保险费等基本社会保险费和住房公积金，准予扣除。

企业为投资者或者职工支付的补充养老保险费、补充医疗保险费，在国务院财政、税务主管部门规定的范围和标准内，准予扣除。

第三十六条 除企业依照国家有关规定为特殊工种职工支付的人身安全保险费和国务院财政、税务主管部门规定可以扣除的其他商业保险费外，企业为投资者或者职工支付的商业保险费，不得扣除。

第三十七条 企业在生产经营活动中发生的合理的不需要资本化的借款费用，准予扣除。

企业为购置、建造固定资产、无形资产和经过12个月以上的建造才能达到预定可销售状态的存货发生借款的，在有关资产购置、建造期间发生的合理的借款费用，应当作为资本性支出计入有关资产的成本，并依照本条例的规定扣除。

第三十八条 企业在生产经营活动中发生的下列利息支出，准予扣除：

（一）非金融企业向金融企业借款的利息支出、金融企业的各项存款利息支出和同业拆借利息支出、企业经批准发行债券的利息支出；

（二）非金融企业向非金融企业借款的利息支出，不超过按照金融企业同期同类贷款利率计算的数额的部分。

第三十九条 企业在货币交易中，以及纳税年度终了时将人民币以外的货币性资产、负债按照期末即期人民币汇率中间价折算为人民币时产生的汇兑损失，除已经计入有关资产成本以及与向所有者进行利润分配相关的部分外，准予扣除。

第四十条 企业发生的职工福利费支出，不超过工资薪金总额14%的部分，准予扣除。

第四十一条 企业拨缴的工会经费，不超过工资薪金总额2%的部分，准予扣除。

第四十二条 除国务院财政、税务主管部门另有规定外，企业发生的职工教育经费支出，不超过工资薪金总额2.5%的部分，准予扣除；超过部分，准予在以后纳税年度结转扣除。

第四十三条 企业发生的与生产经营活动有关的业务招待费支出，按照发生额的60%扣除，但最高不得超过当年销售（营业）收入的5‰。

第四十四条 企业发生的符合条件的广告费和业务宣传费支出，除国务院财政、税务主管部门另有规定外，不超过当年销售（营业）收入15%的部分，准予扣除；超过部分，准予在以后纳税年度结转扣除。

第四十五条 企业依照法律、行政法规有关规定提取的用于环境保护、生态恢复等方面的专项资金，准予扣除。上述专项资金提取后改变用途的，不得扣除。

第四十六条 企业参加财产保险，按照规定缴纳的保险费，准予扣除。

第四十七条 企业根据生产经营活动的需要租入固定资产支付的租赁费，按照以下方法扣除：

（一）以经营租赁方式租入固定资产发生的租赁费支出，按照租赁期限均匀扣除；

（二）以融资租赁方式租入固定资产发生的租赁费支出，按照规定构成融资租入固定资产价值的部分应当提取折旧费用，分期扣除。

第四十八条 企业发生的合理的劳动保护支出，准予扣除。

第四十九条 企业之间支付的管理费、企业内营业机构之间支付的租金和特许权使用费，以及非银行企业内营业机构之间支付的利息，不得扣除。

第五十条 非居民企业在中国境内设立的机构、场所，就其中国境外总机构发生的与该机构、场所生产经营有关的费用，能够提供总机构出具的费用汇集范围、定额、分配依据和方法等证明文件，并合理分摊的，准予扣除。

第五十一条 企业所得税法第九条所称公益性捐赠，是指企业通过公益性社会团体或者县级以上人民政府及其部门，用于《中华人民共和国公益事业捐赠法》规定的公益事业的捐赠。

第五十二条 本条例第五十一条所称公益性社会团体，是指同时符合下列条件的基金会、慈善组织等社会团体：

（一）依法登记，具有法人资格；

（二）以发展公益事业为宗旨，且不以营利为目的；

（三）全部资产及其增值为该法人所有；

（四）收益和营运结余主要用于符合该法人设立目的的事业；

（五）终止后的剩余财产不归属任何个人或者营利组织；

（六）不经营与其设立目的无关的业务；

（七）有健全的财务会计制度；

（八）捐赠者不以任何形式参与社会团体财产的分配；

（九）国务院财政、税务主管部门会同国务院民政部门等登记管理部门规定的其他条件。

第五十三条 企业发生的公益性捐赠支出，不超过年度利润总额12%的部分，准予扣除。

年度利润总额，是指企业依照国家统一会计制度的规定计算的年度会计利润。

第五十四条 企业所得税法第十条第（六）项所称赞助支出，是指企业发生的与生产经营活动无关的各种非广告性质支出。

第五十五条 企业所得税法第十条第（七）项所称未经核定的准备金支出，是指不符合国务院财政、税务主管部门规定的各项资产减值准备、风险准备等准备金支出。

第四节 资产的税务处理

第五十六条 企业的各项资产，包括固定资产、生物资产、无形资产、长期待摊费用、投资资产、存货等，以历史成本为计税基础。

前款所称历史成本，是指企业取得该项资产时实际发生的支出。

企业持有各项资产期间资产增值或者减值，除国务院财政、税务主管部门规定可以确认损益外，不得调整该资产的计税基础。

第五十七条 企业所得税法第十一条所称固定资产，是指企业为生产产品、提供劳务、出租或者经营管理而持有的、使用时间超过12个月的非货币性资产，包括房屋、建筑物、机器、机械、运输工具以及其他与生产经营活动有关的设备、器具、工具等。

第五十八条 固定资产按照以下方法确定计税基础：

（一）外购的固定资产，以购买价款和支付的相关税费以及直接归属于使该资产达到预定用途发生的其他支出为计税基础；

（二）自行建造的固定资产，以竣工结算前发生的支出为计税基础；

（三）融资租入的固定资产，以租赁合同约定的付款总额和承租人在签订租赁合同过程中发生的相关费用为计税基础，租赁合同未约定付款总额的，以该资产的公允价值和承租人在签订租赁合同过程中发生的相关费用为计税基础；

（四）盘盈的固定资产，以同类固定资产的重置完全价值为计税基础；

（五）通过捐赠、投资、非货币性资产交换、债务重组等方式取得的固定资产，以该资产的公允价值和支付的相关税费为计税基础；

（六）改建的固定资产，除企业所得税法第十三条第（一）项和第（二）项规定的支出外，以改建过程中发生的改建支出增加计税基础。

第五十九条 固定资产按照直线法计算的折旧，准予扣除。

企业应当自固定资产投入使用月份的次月起计算折旧；停止使用的固定资产，应当自停止使用月份的次月起停止计算折旧。

企业应当根据固定资产的性质和使用情况，合理确定固定资产的预计净残值。固定资产的预计净残值一经确定，不得变更。

第六十条 除国务院财政、税务主管部门另有规定外，固定资产计算折旧的最低年限如下：

（一）房屋、建筑物，为20年；

（二）飞机、火车、轮船、机器、机械和其他生产设备，为10年；

（三）与生产经营活动有关的器具、工具、家具等，为5年；

（四）飞机、火车、轮船以外的运输工具，为4年；

（五）电子设备，为3年。

第六十一条 从事开采石油、天然气等矿产资源的企业，在开始商业性生产前发生的费用和有关固定资产的折耗、折旧方法，由国务院财政、税务主管部门另行规定。

第六十二条 生产性生物资产按照以下方法确定计税基础：

（一）外购的生产性生物资产，以购买价款和支付的相关税费为计税基础；

（二）通过捐赠、投资、非货币性资产交换、债务重组等方式取得的生产性生物资产，以该资产的公允价值和支付的相关税费为计税基础。

前款所称生产性生物资产，是指企业为生产农产品、提供劳务或者出租等而持有的生物资产，包括经济林、薪炭林、产畜和役畜等。

第六十三条 生产性生物资产按照直线法计算的折旧，准予扣除。

企业应当自生产性生物资产投入使用月份的次月起计算折旧；停止使用的生产性生物资产，应当自停止使用月份的次月起停止计算折旧。

企业应当根据生产性生物资产的性质和使用情况，合理确定生产性生物资产的预计净残值。生产性生物资产的预计净残值一经确定，不得变更。

第六十四条 生产性生物资产计算折旧的最低年限如下：

（一）林木类生产性生物资产，为10年；

（二）畜类生产性生物资产，为3年。

第六十五条 企业所得税法第十二条所称无形资产，是指企业为生产产品、提供劳务、出租或者经营管理而持有的、没有实物形态的非货币性长期资产，包括专利权、商标权、著作权、土地使用权、非专利技术、商誉等。

第六十六条 无形资产按照以下方法确定计税基础：

（一）外购的无形资产，以购买价款和支付的相关税费以及直接归属于使该资产达到预定用途发生的其他支出为计税基础；

（二）自行开发的无形资产，以开发过程中该资产符合资本化条件后至达到预定用途前发生的支出为计税基础；

（三）通过捐赠、投资、非货币性资产交换、债务重组等方式取得的无形资产，以该资产的公允价值和支付的相关税费为计税基础。

第六十七条 无形资产按照直线法计算的摊销费用，准予扣除。

无形资产的摊销年限不得低于10年。

作为投资或者受让的无形资产，有关法律规定或者合同约定了使用年限的，可以按照规定或者约定的使用年限分期摊销。

外购商誉的支出，在企业整体转让或者清算时，准予扣除。

第六十八条 企业所得税法第十三条第（一）项和第（二）项所称固定资产的改建支出，是指改变房屋或者建筑物结构、延长使用年限等发生的支出。

企业所得税法第十三条第（一）项规定的支出，按照固定资产预计尚可使用年限分期摊销；第（二）项规定的支出，按照合同约定的剩余租赁期限分期摊销。

改建的固定资产延长使用年限的，除企业所得税法第十三条第（一）项和第（二）项规定外，应当适当延长折旧年限。

第六十九条 企业所得税法第十三条第（三）项所称固定资产的大修理支出，是指同时符合下列条件的支出：

（一）修理支出达到取得固定资产时的计税基础50%以上；

（二）修理后固定资产的使用年限延长2年以上。

企业所得税法第十三条第（三）项规定的支出，按照固定资产尚可使用年限分期摊销。

第七十条 企业所得税法第十三条第（四）项所称其他应当作为长期待摊费用的支出，自支出发生月份的次月起，分期摊销，摊销年限不得低于3年。

第七十一条 企业所得税法第十四条所称投资资产，是指企业对外进行权益性投资和债权性投资形成的资产。

企业在转让或者处置投资资产时，投资资产的成本，准予扣除。

投资资产按照以下方法确定成本：

（一）通过支付现金方式取得的投资资产，以购买价款为成本；

（二）通过支付现金以外的方式取得的投资资产，以该资产的公允价值和支付的相关税费为成本。

第七十二条 企业所得税法第十五条所称存货，是指企业持有以备出售的产品或者商品、处在生产过程中的在产品、在生产或者提供劳务过程中耗用的材料和物料等。

存货按照以下方法确定成本：

（一）通过支付现金方式取得的存货，以购买价款和支付的相关税费为成本；

（二）通过支付现金以外的方式取得的存货，以该存货的公允价值和支付的相关税费为成本；

（三）生产性生物资产收获的农产品，以产出或者采收过程中发生的材料费、人工费和分摊的间接费用等必要支出为成本。

第七十三条 企业使用或者销售的存货的成本计算方法，可以在先进先出法、加权平均法、个别计价法中选用一种。计价方法一经选用，不得随意变更。

第七十四条 企业所得税法第十六条所称资产的净值和第十九条所称财产净值，是指有关资产、财产的计税基础减除已经按照规定扣除的折旧、折耗、摊销、准备金等后的余额。

第七十五条 除国务院财政、税务主管部门另有规定外，企业在重组过程中，应当在交易发生时确认有关资产的转让所得或者损失，相关资产应当按照交易价格重新确定计税基础。

第三章 应纳税额

第七十六条 企业所得税法第二十二条规定的应纳税额的计算公式为：

应纳税额＝应纳税所得额×适用税率－减免税额－抵免税额

公式中的减免税额和抵免税额，是指依照企业所得税法和国务院的税收优惠规定减征、免征和抵免的应纳税额。

第七十七条 企业所得税法第二十三条所称已在境外缴纳的所得税税额，是指企业来源于中国境外的所得依照中国境外税收法律以及相关规定应当缴纳并已经实际缴纳的企业所得税性质的税款。

第七十八条 企业所得税法第二十三条所称抵免限额，是指企业来源于中国境外的所得，依照企业所得税法和本条例的规定计算的应纳税额。除国务院财政、税务主管部门另有规定外，该抵免限额应当分国（地区）不分项计算，计算公式如下：

抵免限额＝中国境内、境外所得依照企业所得税法和本条例的规定计算的应纳税总额×来源于某国（地区）的应纳税所得额÷中国境内、境外应纳税所得总额

第七十九条 企业所得税法第二十三条所称5个年度，是指从企业取得的来源于中国境外的所得，已经在中国境外缴纳的企业所得税性质的税额超过抵免限额的当年的次年起连续5个纳税年度。

第八十条 企业所得税法第二十四条所称直接控制，是指居民企业直接持有外国企业20%以上股份。

企业所得税法第二十四条所称间接控制，是指居民企业以间接持股方式持有外国企业20%以上股份，具体认定办法由国务院财政、税务主管部门另行制定。

第八十一条 企业依照企业所得税法第二十三条、第二十四条的规定抵免企业所得税税额时，应当提供中国境外税务机关出具的税款所属年度的有关纳税凭证。

第四章 税收优惠

第八十二条 企业所得税法第二十六条第（一）项所称国债利息收入，是指企业持有国务院财政部门发行的国债取得的利息收入。

第八十三条 企业所得税法第二十六条第（二）项所称符合条件的居民企业之间的股息、红利等权益性投资收益，是指居民企业直接投资于其他居民企业取得的投资收 益。企业所得税法第二十六条第（二）项和第（三）项所称股息、红利等权

益性投资收益，不包括连续持有居民企业公开发行并上市流通的股票不足12个月取得的 投资收益。

第八十四条 企业所得税法第二十六条第（四）项所称符合条件的非营利组织，是指同时符合下列条件的组织：

（一）依法履行非营利组织登记手续；

（二）从事公益性或者非营利性活动；

（三）取得的收入除用于与该组织有关的、合理的支出外，全部用于登记核定或者章程规定的公益性或者非营利性事业；

（四）财产及其孳息不用于分配；

（五）按照登记核定或者章程规定，该组织注销后的剩余财产用于公益性或者非营利性目的，或者由登记管理机关转赠给与该组织性质、宗旨相同的组织，并向社会公告；

（六）投入人对投入该组织的财产不保留或者享有任何财产权利；

（七）工作人员工资福利开支控制在规定的比例内，不变相分配该组织的财产。

前款规定的非营利组织的认定管理办法由国务院财政、税务主管部门会同国务院有关部门制定。

第八十五条 企业所得税法第二十六条第（四）项所称符合条件的非营利组织的收入，不包括非营利组织从事营利性活动取得的收入，但国务院财政、税务主管部门另有规定的除外。

第八十六条 企业所得税法第二十七条第（一）项规定的企业从事农、林、牧、渔业项目的所得，可以免征、减征企业所得税，是指：

（一）企业从事下列项目的所得，免征企业所得税：

1. 蔬菜、谷物、薯类、油料、豆类、棉花、麻类、糖料、水果、坚果的种植；
2. 农作物新品种的选育；
3. 中药材的种植；
4. 林木的培育和种植；
5. 牲畜、家禽的饲养；
6. 林产品的采集；
7. 灌溉、农产品初加工、兽医、农技推广、农机作业和维修等农、林、牧、渔服务业项目；
8. 远洋捕捞。

（二）企业从事下列项目的所得，减半征收企业所得税：

1. 花卉、茶以及其他饮料作物和香料作物的种植；
2. 海水养殖、内陆养殖。

企业从事国家限制和禁止发展的项目，不得享受本条规定的企业所得税优惠。

第八十七条 企业所得税法第二十七条第（二）项所称国家重点扶持的公共基础设施项目，是指《公共基础设施项目企业所得税优惠目录》规定的港口码头、机场、铁路、公路、城市公共交通、电力、水利等项目。

企业从事前款规定的国家重点扶持的公共基础设施项目的投资经营的所得，自项目取得第一笔生产经营收入所属纳税年度起，第一年至第三年免征企业所得税，第四年至第六年减半征收企业所得税。

企业承包经营、承包建设和内部自建自用本条规定的项目，不得享受本条规定的企业所得税优惠。

第八十八条　企业所得税法第二十七条第（三）项所称符合条件的环境保护、节能节水项目，包括公共污水处理、公共垃圾处理、沼气综合开发利用、节能减排技术改造、海水淡化等。项目的具体条件和范围由国务院财政、税务主管部门商国务院有关部门制订，报国务院批准后公布施行。

企业从事前款规定的符合条件的环境保护、节能节水项目的所得，自项目取得第一笔生产经营收入所属纳税年度起，第一年至第三年免征企业所得税，第四年至第六年减半征收企业所得税。

第八十九条　依照本条例第八十七条和第八十八条规定享受减免税优惠的项目，在减免税期限内转让的，受让方自受让之日起，可以在剩余期限内享受规定的减免税优惠；减免税期限届满后转让的，受让方不得就该项目重复享受减免税优惠。

第九十条　企业所得税法第二十七条第（四）项所称符合条件的技术转让所得免征、减征企业所得税，是指一个纳税年度内，居民企业技术转让所得不超过500万元的部分，免征企业所得税；超过500万元的部分，减半征收企业所得税。

第九十一条　非居民企业取得企业所得税法第二十七条第（五）项规定的所得，减按10%的税率征收企业所得税。

下列所得可以免征企业所得税：

（一）外国政府向中国政府提供贷款取得的利息所得；

（二）国际金融组织向中国政府和居民企业提供优惠贷款取得的利息所得；

（三）经国务院批准的其他所得。

第九十二条　企业所得税法第二十八条第一款所称符合条件的小型微利企业，是指从事国家非限制和禁止行业，并符合下列条件的企业：

（一）工业企业，年度应纳税所得额不超过30万元，从业人数不超过100人，资产总额不超过3000万元；

（二）其他企业，年度应纳税所得额不超过30万元，从业人数不超过80人，资产总额不超过1000万元。

第九十三条　企业所得税法第二十八条第二款所称国家需要重点扶持的高新技术企业，是指拥有核心自主知识产权，并同时符合下列条件的企业：

（一）产品（服务）属于《国家重点支持的高新技术领域》规定的范围；

（二）研究开发费用占销售收入的比例不低于规定比例；

（三）高新技术产品（服务）收入占企业总收入的比例不低于规定比例；

（四）科技人员占企业职工总数的比例不低于规定比例；

（五）高新技术企业认定管理办法规定的其他条件。

《国家重点支持的高新技术领域》和高新技术企业认定管理办法由国务院科技、财政、税务主管部门商国务院有关部门制订，报国务院批准后公布施行。

第九十四条　企业所得税法第二十九条所称民族自治地方，是指依照《中华人民共和国民族区域自治法》的规定，实行民族区域自治的自治区、自治州、自治县。

对民族自治地方内国家限制和禁止行业的企业，不得减征或者免征企业所得税。

第九十五条 企业所得税法第三十条第（一）项所称研究开发费用的加计扣除，是指企业为开发新技术、新产品、新工艺发生的研究开发费用，未形成无形资产计入当 期损益的，在按照规定据实扣除的基础上，按照研究开发费用的50%加计扣除；形成无形资产的，按照无形资产成本的150%摊销。

第九十六条 企业所得税法第三十条第（二）项所称企业安置残疾人员所支付的工资的加计扣除，是指企业安置残疾人员的，在按照支付给残疾职工工资据实扣除的基础上，按照支付给残疾职工工资的100%加计扣除。残疾人员的范围适用《中华人民共和国残疾人保障法》的有关规定。

企业所得税法第三十条第（二）项所称企业安置国家鼓励安置的其他就业人员所支付的工资的加计扣除办法，由国务院另行规定。

第九十七条 企业所得税法第三十一条所称抵扣应纳税所得额，是指创业投资企业采取股权投资方式投资于未上市的中小高新技术企业2年以上的，可以按照其投资额的70%在股权持有满2年的当年抵扣该创业投资企业的应纳税所得额；当年不足抵扣的，可以在以后纳税年度结转抵扣。

第九十八条 企业所得税法第三十二条所称可以采取缩短折旧年限或者采取加速折旧的方法的固定资产，包括：

（一）由于技术进步，产品更新换代较快的固定资产；

（二）常年处于强震动、高腐蚀状态的固定资产。

采取缩短折旧年限方法的，最低折旧年限不得低于本条例第六十条规定折旧年限的60%；采取加速折旧方法的，可以采取双倍余额递减法或者年数总和法。

第九十九条 企业所得税法第三十三条所称减计收入，是指企业以《资源综合利用企业所得税优惠目录》规定的资源作为主要原材料，生产国家非限制和禁止并符合国家和行业相关标准的产品取得的收入，减按90%计入收入总额。

前款所称原材料占生产产品材料的比例不得低于《资源综合利用企业所得税优惠目录》规定的标准。

第一百条 企业所得税法第三十四条所称税额抵免，是指企业购置并实际使用《环境保护专用设备企业所得税优惠目录》、《节能节水专用设备企业所得税优惠目录》 和《安全生产专用设备企业所得税优惠目录》规定的环境保护、节能节水、安全生产等专用设备的，该专用设备的投资额的10%可以从企业当年的应纳税额中抵 免；当年不足抵免的，可以在以后5个纳税年度结转抵免。

享受前款规定的企业所得税优惠的企业，应当实际购置并自身实际投入使用前款规定的专用设备；企业购置上述专用设备在5年内转让、出租的，应当停止享受企业所得税优惠，并补缴已经抵免的企业所得税税款。

第一百零一条 本章第八十七条、第九十九条、第一百条规定的企业所得税优惠目录，由国务院财政、税务主管部门商国务院有关部门制订，报国务院批准后公布施行。

第一百零二条 企业同时从事适用不同企业所得税待遇的项目的，其优惠项目应当单独计算所得，并合理分摊企业的期间费用；没有单独计算的，不得享受企业所得税优惠。

第五章 源泉扣缴

第一百零三条 依照企业所得税法对非居民企业应当缴纳的企业所得税实行源泉扣缴的，应当依照企业所得税法第十九条的规定计算应纳税所得额。

企业所得税法第十九条所称收入全额，是指非居民企业向支付人收取的全部价款和价外费用。

第一百零四条 企业所得税法第三十七条所称支付人，是指依照有关法律规定或者合同约定对非居民企业直接负有支付相关款项义务的单位或者个人。

第一百零五条 企业所得税法第三十七条所称支付，包括现金支付、汇拨支付、转账支付和权益兑价支付等货币支付和非货币支付。

企业所得税法第三十七条所称到期应支付的款项，是指支付人按照权责发生制原则应当计入相关成本、费用的应付款项。

第一百零六条 企业所得税法第三十八条规定的可以指定扣缴义务人的情形，包括：

（一）预计工程作业或者提供劳务期限不足一个纳税年度，且有证据表明不履行纳税义务的；

（二）没有办理税务登记或者临时税务登记，且未委托中国境内的代理人履行纳税义务的；

（三）未按照规定期限办理企业所得税纳税申报或者预缴申报的。

前款规定的扣缴义务人，由县级以上税务机关指定，并同时告知扣缴义务人所扣税款的计算依据、计算方法、扣缴期限和扣缴方式。

第一百零七条 企业所得税法第三十九条所称所得发生地，是指依照本条例第七条规定的原则确定的所得发生地。在中国境内存在多处所得发生地的，由纳税人选择其中之一申报缴纳企业所得税。

第一百零八条 企业所得税法第三十九条所称该纳税人在中国境内其他收入，是指该纳税人在中国境内取得的其他各种来源的收入。

税务机关在追缴该纳税人应纳税款时，应当将追缴理由、追缴数额、缴纳期限和缴纳方式等告知该纳税人。

第六章 特别纳税调整

第一百零九条 企业所得税法第四十一条所称关联方，是指与企业有下列关联关系之一的企业、其他组织或者个人：

（一）在资金、经营、购销等方面存在直接或者间接的控制关系；

（二）直接或者间接地同为第三者控制；

（三）在利益上具有相关联的其他关系。

第一百一十条 企业所得税法第四十一条所称独立交易原则，是指没有关联关系的交易各方，按照公平成交价格和营业常规进行业务往来遵循的原则。

第一百一十一条 企业所得税法第四十一条所称合理方法，包括：

（一）可比非受控价格法，是指按照没有关联关系的交易各方进行相同或者类似业务往来的价格进行定价的方法；

（二）再销售价格法，是指按照从关联方购进商品再销售给没有关联关系的交易方的价格，减除相同或者类似业务的销售毛利进行定价的方法；

（三）成本加成法，是指按照成本加合理的费用和利润进行定价的方法；

（四）交易净利润法，是指按照没有关联关系的交易各方进行相同或者类似业务往来取得的净利润水平确定利润的方法；

（五）利润分割法，是指将企业与其关联方的合并利润或者亏损在各方之间采用合理标准进行分配的方法；

（六）其他符合独立交易原则的方法。

第一百一十二条　企业可以依照企业所得税法第四十一条第二款的规定，按照独立交易原则与其关联方分摊共同发生的成本，达成成本分摊协议。

企业与其关联方分摊成本时，应当按照成本与预期收益相配比的原则进行分摊，并在税务机关规定的期限内，按照税务机关的要求报送有关资料。

企业与其关联方分摊成本时违反本条第一款、第二款规定的，其自行分摊的成本不得在计算应纳税所得额时扣除。

第一百一十三条　企业所得税法第四十二条所称预约定价安排，是指企业就其未来年度关联交易的定价原则和计算方法，向税务机关提出申请，与税务机关按照独立交易原则协商、确认后达成的协议。

第一百一十四条　企业所得税法第四十三条所称相关资料，包括：

（一）与关联业务往来有关的价格、费用的制定标准、计算方法和说明等同期资料；

（二）关联业务往来所涉及的财产、财产使用权、劳务等的再销售（转让）价格或者最终销售（转让）价格的相关资料；

（三）与关联业务调查有关的其他企业应当提供的与被调查企业可比的产品价格、定价方式以及利润水平等资料；

（四）其他与关联业务往来有关的资料。

企业所得税法第四十三条所称与关联业务调查有关的其他企业，是指与被调查企业在生产经营内容和方式上相类似的企业。

企业应当在税务机关规定的期限内提供与关联业务往来有关的价格、费用的制定标准、计算方法和说明等资料。关联方以及与关联业务调查有关的其他企业应当在税务机关与其约定的期限内提供相关资料。

第一百一十五条　税务机关依照企业所得税法第四十四条的规定核定企业的应纳税所得额时，可以采用下列方法：

（一）参照同类或者类似企业的利润率水平核定；

（二）按照企业成本加合理的费用和利润的方法核定；

（三）按照关联企业集团整体利润的合理比例核定；

（四）按照其他合理方法核定。

企业对税务机关按照前款规定的方法核定的应纳税所得额有异议的，应当提供相关证据，经税务机关认定后，调整核定的应纳税所得额。

第一百一十六条　企业所得税法第四十五条所称中国居民，是指根据《中华人民共和国个人所得税法》的规定，就其从中国境内、境外取得的所得在中国缴纳个人所得税的个人。

第一百一十七条　企业所得税法第四十五条所称控制，包括：

（一）居民企业或者中国居民直接或者间接单一持有外国企业10%以上有表决权股份，且由其共同持有该外国企业50%以上股份；

（二）居民企业，或者居民企业和中国居民持股比例没有达到第（一）项规定的标准，但在股份、资金、经营、购销等方面对该外国企业构成实质控制。

第一百一十八条　企业所得税法第四十五条所称实际税负明显低于企业所得税法第四条第一款规定税率水平，是指低于企业所得税法第四条第一款规定税率的50%。

第一百一十九条　企业所得税法第四十六条所称债权性投资，是指企业直接或者间接从关联方获得的，需要偿还本金和支付利息或者需要以其他具有支付利息性质的方式予以补偿的融资。

企业间接从关联方获得的债权性投资，包括：

（一）关联方通过无关联第三方提供的债权性投资；

（二）无关联第三方提供的、由关联方担保且负有连带责任的债权性投资；

（三）其他间接从关联方获得的具有负债实质的债权性投资。

企业所得税法第四十六条所称权益性投资，是指企业接受的不需要偿还本金和支付利息，投资人对企业净资产拥有所有权的投资。

企业所得税法第四十六条所称标准，由国务院财政、税务主管部门另行规定。

第一百二十条　企业所得税法第四十七条所称不具有合理商业目的，是指以减少、免除或者推迟缴纳税款为主要目的。

第一百二十一条　税务机关根据税收法律、行政法规的规定，对企业作出特别纳税调整的，应当对补征的税款，自税款所属纳税年度的次年6月1日起至补缴税款之日止的期间，按日加收利息。

前款规定加收的利息，不得在计算应纳税所得额时扣除。

第一百二十二条　企业所得税法第四十八条所称利息，应当按照税款所属纳税年度中国人民银行公布的与补税期间同期的人民币贷款基准利率加5个百分点计算。

企业依照企业所得税法第四十三条和本条例的规定提供有关资料的，可以只按前款规定的人民币贷款基准利率计算利息。

第一百二十三条　企业与其关联方之间的业务往来，不符合独立交易原则，或者企业实施其他不具有合理商业目的安排的，税务机关有权在该业务发生的纳税年度起10年内，进行纳税调整。

第七章 征收管理

第一百二十四条　企业所得税法第五十条所称企业登记注册地，是指企业依照国家有关规定登记注册的住所地。

第一百二十五条　企业汇总计算并缴纳企业所得税时，应当统一核算应纳税所得额，具体办法由国务院财政、税务主管部门另行制定。

第一百二十六条　企业所得税法第五十一条所称主要机构、场所，应当同时符合下列条件：

（一）对其他各机构、场所的生产经营活动负有监督管理责任；

（二）设有完整的账簿、凭证，能够准确反映各机构、场所的收入、成本、费用和盈亏情况。

第一百二十七条　企业所得税法第五十一条所称经税务机关审核批准，是指经各机构、场所所在地税务机关的共同上级税务机关审核批准。

非居民企业经批准汇总缴纳企业所得税后，需要增设、合并、迁移、关闭机构、场所或者停止机构、场所业务的，应当事先由负责汇总申报缴纳企业所得税的主要机构、场所向其所在地税务机关报告；需要变更汇总缴纳企业所得税的主要机构、场所的，依照前款规定办理。

第一百二十八条　企业所得税分月或者分季预缴，由税务机关具体核定。

企业根据企业所得税法第五十四条规定分月或者分季预缴企业所得税时，应当按照月度或者季度的实际利润额预缴；按照月度或者季度的实际利润额预缴有困难的，　可以按照上一纳税年度应纳税所得额的月度或者季度平均额预缴，或者按照经税务机关认可的其他方法预缴。预缴方法一经确定，该纳税年度内不得随意变更。

第一百二十九条 企业在纳税年度内无论盈利或者亏损，都应当依照企业所得税法第五十四条规定的期限，向税务机关报送预缴企业所得税纳税申报表、年度企业所得税纳税申报表、财务会计报告和税务机关规定应当报送的其他有关资料。

第一百三十条 企业所得以人民币以外的货币计算的，预缴企业所得税时，应当按照月度或者季度最后一日的人民币汇率中间价，折合成人民币计算应纳税所得额。年 度终了汇算清缴时，对已经按照月度或者季度预缴税款的，不再重新折合计算，只就该纳税年度内未缴纳企业所得税的部分，按照纳税年度最后一日的人民币汇率中 间价，折合成人民币计算应纳税所得额。

经税务机关检查确认，企业少计或者多计前款规定的所得的，应当按照检查确认补税或者退税时的上一个月最后一日的人民币汇率中间价，将少计或者多计的所得折合成人民币计算应纳税所得额，再计算应补缴或者应退的税款。

第八章 附则

第一百三十一条 企业所得税法第五十七条第一款所称本法公布前已经批准设立的企业，是指企业所得税法公布前已经完成登记注册的企业。

第一百三十二条 在香港特别行政区、澳门特别行政区和台湾地区成立的企业，参照适用企业所得税法第二条第二款、第三款的有关规定。

第一百三十三条 本条例自2008年1月1日起施行。1991年6月30日国务院发布的《中华人民共和国外商投资企业和外国企业所得税法实施细则》和1994年2月4日财政部发布的《中华人民共和国企业所得税暂行条例实施细则》同时废止。

Glossary

APA	Advance Pricing Arrangement
BPO	Business process outsourcing
CDM	Clean Development Mechanism
CER	Certified emission reduction
CIT	Corporate Income Tax
CIT Law	PRC Corporate Income Tax Law
CIT Implementation Rules	Detailed Rules for the Implementations of PRC Corporate Income Tax Law
CPLM	Cost Plus Method
CSA	Cost Sharing Agreement
CUP	Comparable Uncontrolled Price Method
EIT Regulations	Provisional Regulations of the PRC on Enterprise Income Tax (effective from January 1, 1994 to December 31, 2007)
EUR	Euro
FEIT	Foreign Enterprise Income Tax (applicable for foreign enterprises and foreign invested enterprises for the period from July 1, 1991 to December 31, 2007)
FEIT law	The Income Tax Law of the PRC for Foreign Invested Enterprises and Foreign Enterprises (effective July 1, 1991—December 31, 2007)
FEIT Regulations	Detailed Rules for Implementation of the Income Tax Law of the PRC for Foreign Invested Enterprises and Foreign Enterprises (effective July 1, 1991—December 31, 2007)
KPO	Knowledge process outsourcing

IP	Intellectual property
ITO	Information technology outsourcing
MOF	The Ministry of Finance
NPC	National People's Congress
OECD	Organization for Economic Co-operation and Development
PRC	The People's Republic of China
R&D	Research and development
RMB	Renminbi Yuan, Chinese currency
RPM	Resale Price Method
PSM	Profit Split Method
SAR	Special Administrative Region of PRC
SAT	The State Administration of Taxation
TNMM	Transactional Net Margin Method
USD	United States dollar
WFOE	Wholly foreign owned enterprise
WTO	World Trade Organization

Key Words

Administrative appeal
Advertising expenses
Amortization
Appeal
Asset loss
- Approved loss
- Bank deposit loss
- Cash loss
- Credit card loss
- Evidence
- Inventory loss
- Loss of fixed assets
- Loss of productive biological assets
- Loss on bad loans
- Loss on guarantee
- Loss on student loans
- Self claimed loss
- Uncollected receivables

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Capital gain
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- Definition
- Inclusion of undistributed profits
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- Definition of fixed asset
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- Expenses of acquisition of exploration right
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  From state treasury debts
  Interest expense paid to non-financial
    institution
  Received by nonresident enterprises
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  Tax year
  Treatment to liquidating company
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  Administrative compensation
  Enforcement of judgment
  Judicial system
  Petition for review
  Trial in first instance
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  Establishment or place of business
  Income not connected with establishment
    in China
  Permanent Establishment
  Production sharing contract
  Representative office
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  Administrative penalty
  Criminal penalty
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Permanent establishment
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  Credit guarantee company
  Exchange risk fund
  Futures company risk fund
  Futures exchange risk fund
  Futures investor protection fund
  Incurred and reported outstanding loss reserve
  Incurred but not reported outstanding loss reserve
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  Late payment charges
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  Provisional tax filing and payment
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  Tax registration
  Translation of foreign currency
  Withholding tax

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- Animation enterprise
- Clean development mechanism projects
- Culture enterprises
- Employment of disabled personnel
- Environmental protection
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- Integrated circuit production enterprise
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- Income not effectively connected with establishment in China
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