FINDING AIDS **763**

Abbreviations 765
Legislation Finding List 769
Index 783

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PART I: INTRODUCTION

Page

Legal and Administrative Framework of China Tax 3
Introduction to China Taxes 13

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Chapter 1

Legal and Administrative Framework of China Tax

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

¶1-010 Tax reform background

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

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

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

In addition to Enterprise Income Tax (EIT), China has witnessed reforms or amendments of other non-EIT taxes a few times in the past three decades, including Value-added Tax (VAT), Business Tax (BT), Individual Income Tax (IIT), Consumption Tax (CT), Urban Township Land Use Tax (UTLUT), Real Estate Tax (RET), etc. The IIT law was last amended on 30 June 2011; the UTLUT regulation was last amended on 30 December 2006; the regulations for VAT, BT and CT were last amended in November 2008.

Starting from 1 January 2012, China has launched a pilot VAT programme where the taxation of specified sectors will transition to being subject to VAT rather than BT. The pilot programme initially applies to transportation and modern service industries in Shanghai and was rolled out to eight other cities/ provinces during 2012, and the nationwide rollout was on 1 August 2013. In addition, the pilot programme gradually extends to other services sections, e.g. the postal services (from 1 January 2014) and telecommunication industry (from 1 June 2014) have been brought into the pilot programme.

The Urban Real Estate Tax (URET) regulation previously applicable to foreign investment enterprises, foreign enterprises and foreigners was abolished on 31 December 2008; instead, RET regulation has been applied to foreign investment enterprises, foreign enterprises and foreigners from 1 January 2009.

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

¶1-020 Sources of law

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

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

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

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

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approved by the State Council. People's Governments in these jurisdictions are also authorised to make provisions or measures.

¶1-030 Types of laws and regulations

Laws promulgated by National People's Congress

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

- basic laws; or
- laws and amendments.

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

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

Administrative regulations issued by the State Council

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

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

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

Other administrative documents

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

Many of these documents have been classified as "internal" and for these, foreigners must rely on the opinion of professional advisors, or on unofficial

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summaries of the documents provided by Chinese business partners, in order to understand how the documents affect and alter the published laws and regulations. Chinese legal officials have recognised that practices regarding "internal" law are unsatisfactory and have pledged to reduce the number of such documents.

Local regulations and rules

There are three types of local regulations:

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

Made at a provincial level, these regulations must first be reviewed by the Legal Work Committee of NPC to ensure that they do not conflict with the Constitution. The State Council also examines the legislation to ensure that it does not conflict with other administrative laws or superior regulations. Local regulations made below provincial level must be approved by the legislative authorities at the provincial level.

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

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

¶1-040 Language and interpretation of laws

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

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

- *Legislative interpretation* — the Standing Committee of the NPC interprets the Constitution, laws enacted by the NPC and laws enacted by itself which need to be further clarified or supplemented.

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- *Administrative or executive interpretation* — the State Council interprets administrative regulations where questions arise relating to their application. The interpretation has the same effect as the administrative regulation in question. Ministries under the State Council interpret the rules they have made and the interpretation has the same effect as the rules in question.
- *Local interpretation* — the standing committees of provincial People's Congresses supplement or clarify the scope of local regulations and rules that they have issued. Provincial governments and their departments interpret questions of regulations arising out of their respective local rules and regulations. The interpretation has the same effect as the rules or regulations in question and is only binding in the jurisdiction concerned.
- *Judicial interpretation* — technically, the Supreme People's Court and the Supreme People's Procuratorate are limited to making binding interpretations of laws only within the context of trial and procuratorial work. However, the power of the Supreme People's Court to interpret national legislation has been expanding in practice. The Court has given detailed "explanations" of major laws (e.g. *Civil Law, Security Law*) without which it would be impossible to enforce national laws which have been framed in general principles and vague terms. The power of the Supreme People's Court is, however, restricted to interpreting laws promulgated by the NPC and its Standing Committee (except the Constitution). Generally, it will not interpret administrative regulations, government rules or local rules and regulations.

¶1-050 Tax policy and administration

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

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

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

Local taxes are handled by bureaus of local tax in the relevant locations. Local tax bureaus are responsible for collecting taxes that only generate revenue for the respective local governments. Although the authority for

Chapter 3

Individuals and Enterprises Liable to Income Tax

INDIVIDUALS

Residence and source of income ¶3-010
Domicile test and length of residence or visit ¶3-020
Expatriates living in China ¶3-030
Tax relief for temporary visitors ¶3-040
Expatriate senior managements ¶3-050
Annual tax return ¶3-060
PRC social security contributions for foreigners ¶3-070

ENTERPRISES

Background ¶3-200
Types of taxpayers ¶3-210
Types of foreign investment enterprises
Equity joint ventures ¶3-220
Cooperative joint ventures ¶3-230
Wholly foreign-owned enterprises ¶3-240
Chinese holding companies ¶3-250
Foreign enterprises with or without establishments in China ¶3-260
Cooperative arrangements ¶3-270
Branch offices ¶3-280
Representative offices ¶3-290
Partnership ¶3-295
Consulting services rendered in China ¶3-300
Domestic enterprises ¶3-500
Scope of tax liability ¶3-620
Grandfather rule ¶3-630

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INDIVIDUALS

¶3-010 Residence and source of income

The key factors for determining whether an individual shall pay individual income tax in China, and the scope of his/her income tax liability, are whether the individual is domiciled in China, the length of the individual's stay in China, and the source of his/her income. In this regard:

- Individuals who are domiciled in China are subject to tax on their worldwide income (see ¶3-020).
- Individuals who are not domiciled in China (Non-China domiciled individuals) who have lived in China for *more than five full consecutive years* are subject to tax on their worldwide income (see ¶3-030) in any subsequent year which the individuals lived in China for one full year.
- Non-China domiciled individuals who have *lived* in China for *one year or more* (but less than five years) are subject to tax on their China-sourced income plus any non China-sourced income which is paid to them by an individual or enterprise located in China (see ¶3-030).
- Non-China domiciled individuals who have *lived* in China for *more than 90 days* in a tax year, or *more than 183 days* if they are tax resident of the country with which China has a tax treaty in a prescribed period, are subject to tax only on their China-sourced income (see ¶3-030).
- Temporary visitors who visit China for *less than 90 days or 183 days* (if a tax treaty applies) are only subject to tax on China-sourced employment income they receive which is paid or borne by an establishment in China (see ¶3-040).

¶3-020 Domicile test and length of residence or visit

Domicile test for residence

An individual who is a usual resident of China is liable to pay individual income tax on his/her worldwide income derived from sources both within and outside China (*Individual Income Tax Law* (IITL), Art 1). The test for residence in China is whether the individual usually or habitually resides in China due to "household registration, family or economic relationship" (*Individual Income Tax Implementing Rules* (IITIR), Art 2).

This domicile test refers to the taxpayer's personal connections within the territory of China. An individual who temporarily lives abroad (e.g. to undertake education, employment, work assignments, visits to family or touring, etc.) and who must return to China due to the above connections is regarded as being a usual resident of or usually domiciled in China (*Guoshuifa* (1994) 89, Art 1). In practice, foreign individuals working in China (Expatriates) are normally considered as a non-China domiciled individual, but each case requires detailed review to assess the residency status.

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Rules for calculating length of stay or visit

The tax liability of an individual who does not usually or habitually reside in China depends upon the number of days during which he/she has lived in or visited China.

The following rules apply when calculating whether the individual has lived in China for more or less than one year, or more or less than five years, or whether he/she will qualify for tax relief as a "temporary visitor":

- A length of stay is calculated based on entry and exit documents. Valid evidence includes a passport, home visit certificate (for Hong Kong and Macau residents) or a mainland visit permit (for Taiwan residents) (*Guoshuihanfa* (1995) 125, Art 5).
- Prior to 1 July 2004, in counting the 90/183 days to determine one's tax obligation in China, the entry day was counted while the exit day was not. Effective from 1 July 2004, both the entry day and the exit day count as days spent in the mainland. If a person enters and departs on the same day, it is counted as one day (*Guoshuifa* (2004) 97, Art 1).
- For counting the "actual working period" within China for tax calculation on time apportionment purpose, previously only the entry day was counted while the exit day was not. Effective from 1 July 2004, both the entry day and the exit day are counted as half-day each. Entry and exit on the same day is also counted as half-day (*Guoshuifa* (2004) 97, Art 2).
- The "actual present days" are used for eligible Hong Kong or Macau tax residents to calculate the IIT under time-apportionment methods stipulated in the *Bulletin of the SAT* (2012) 16 (Bulletin 16). For counting the "actual present days" under Bulletin 16, the day of entry and day of exit are each counted as half-day. Likewise, day on which the individual crosses the border more than once are also counted as half-day.
- A "tax year" starts on 1 January and ends on 31 December (IITIR, Art 46). An individual who has lived in China for 365 days of a tax year is regarded as having lived in China for a full year (IITIR, Art 3).
- A single temporary absence from China not exceeding 30 days, or multiple absences not exceeding a total of 90 days within a tax year, is not deducted from the total days spent in China for the purposes of determining whether an individual has lived in China for a full year (IITIR, Art 3).
- An individual who has lived in China for the whole of each tax year for a continuous five-year period is regarded as having lived in China for five full years (*Caishuizi* (1995) 98, Art 1).

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Example

Mr W is a Singaporean who arrived in China to live and work in December 2003. During 2004, he made several trips out of China. Based on the arrival and departure dates recorded in his passport, Mr W's length of stay in China to the end of the 2004 tax year is calculated as follows:

Periods of absence from China	*Length of absence*
Departure 29 January 2004 — return 5 February 2004	7 days (old rule)
Departure 1 July 2004 — return 25 July 2004	23 days (new rule)
Departure 15 October 2004 — return 10 November 2004	25 days (new rule)
Total	55 days

Length of stay in 2003 = 31 days (December 2003)

Length of stay in 2004 = 365 days (2004) – 0 (absence in 2004) = 365 days

None of Mr W's individual absences in 2004 exceeded 30 days and the days absent from China totaled less than 90 days. Therefore, Mr W's absences from China would not be deducted from the days spent in China and he would be regarded as having lived in China for more than one year.

Tax relief for temporary visitors

Tax relief is provided for temporary visitors who have lived in China for a total of 90 days or less in a tax year under the IITIR. China's tax treaties provide tax relief for temporary visitors who have lived in China for a total of 183 days or less within either a tax year, a calendar year, any twelve-month period, or within 365 days — the time period within which the length of stay is calculated varies from treaty to treaty. If the calculation is based on the calendar year or tax year, it is made within the period from 1 January to 31 December. If the calculation is based on any twelve-month or 365-day period, the relevant period starts from the day on which the individual arrives in China (*Guoshuifa* (1995) 155, Art 1).

¶3-030 Expatriates living in China

Expatriates living in China for more than one year but less than five years

Individuals who have lived in China for 365 days in a calendar year are deemed to have lived in China for one full year. A "temporary absence" from

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China of 30 days or less, or multiple temporary absences totaling 90 days or less within a tax year, is not deducted for the purpose of calculating the number of days an individual has lived in China (IITIR, Art 3).

The IITL states that individuals who are not domiciled in China (see ¶3-010 above), but have lived in China for at least one full year, are subject to individual income tax on their worldwide income derived from sources within and outside China (IITL, Art 1). However, as a concession, a non-domiciled individual who has lived in China for more than one year, but not more than five years, subject to approval by the competent tax authorities, may be taxed only on the portion of his/her income which is derived from China. The foreign-sourced income will not be taxable unless it is paid by individuals or enterprises in China (IITIR, Art 6).

If employment income is derived from a period of work during a "temporary absence" (i.e. single absence of 30 days or less, or multiple absences totaling 90 days or less within a tax year), individual income tax is payable only on the portion of that income which is paid by a Chinese enterprise or Chinese individual employer (*Guoshuifa* (1994) 148, Art 4).

Once an individual has lived in China continuously for more than five years, he/she shall pay income tax on his/her worldwide income, i.e. all income derived from both within and outside China, for every full year spent in China after the fifth year (IITIR, Art 6).

Expatriates living in China for more than five years

Individuals who have lived in China for a continuous five-year period are thereafter subject to individual income tax on their worldwide income while they continue to live in China.

Caishuizi (1995) 98 issued by the Ministry of Finance (MOF) and the State Administration of Taxation (SAT) clarifies the five-year rule as follows:

- An individual taxpayer is considered to have lived in China continuously for five years if he/she has been residing in China consecutively for a full year in each of the past five years. (Temporary absences — i.e. a single absence of 30 days or less or multiple absences totaling 90 days or less — are not deducted from the total days spent in China for the purposes of determining whether an individual has lived in China for a full year.)
- If the five-year residence is established, the taxpayer will be subject to income tax on his/her income from sources within and outside China if he lives in China for one full year in any of the year from the sixth year onwards.
- If, in any year thereafter, the taxpayer does not live in China for the full year, he/she will be subject to individual income tax only on his/her China-sourced income for that year.

Chapter 13

Value-Added Tax

Introduction to value-added tax .... ¶13-010

LIABILITY TO TAX

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

TAX CALCULATION

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

VAT TREATMENT OF EXPORTS

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

http://www.pbookshop.com

PAYMENT OF VAT

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

VAT INVOICES

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

VAT REFORM — PILOT PROGRAMME

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

¶13-010 Introduction to value-added tax

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

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

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

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

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

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VAT payable by taxpayers is calculated as follows:

(1) A taxpayer who engages in the sale of goods or the provision of taxable services will calculate the tax based on the amount received from the sale of goods or taxable services by applying a given tax rate.

(2) The tax thus calculated, the "output tax", is reduced by the amount of "input tax" that has been paid on the purchase of goods or taxable services as indicated on the VAT invoices issued with the purchases (see ¶13-910).

(3) The net amount is the VAT payable by the taxpayer.

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

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

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

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

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

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On 26 October 2011, the State Council announced that it would launch the pilot VAT reform programme on 1 January 2012. The pilot programme initially applied to transportation and modern service industries in Shanghai and was rolled out to other eight provinces and areas in 2012; it was further rolled out nationwide on transportation and certain service industries on 1 August 2013.

On 4 December 2013, the State Council decided that railway transportation and postal services would also be included within the scope of the VAT reform pilot programme on 1 January 2014. Subsequently, on 30 April 2014, China's Ministry of Finance (MOF) and State Administration of Taxation (SAT) announced that telecommunications services have also been included within the scope of the VAT reform as from 1 June 2014.

The aim of the pilot programme is to resolve the double taxation issues under the prevailing system and to foster the development of specified modern service industries by gradually transitioning these industries from liability to business tax (BT) to liability to VAT (see ¶13-1010 to ¶13-1095).

LIABILITY TO TAX

¶13-110 Goods and services subject to VAT

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

PRVATIR (Art 2) clarifies the scope of VAT:

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

Additional activities within scope of VAT

VAT is also currently levied on:

- the sale of commodity futures and precious metal futures — VAT is levied when the futures are recognised and realised (*Guoshuifa* (1993) 154; *Guoshuifa* (1994) 244);
- the sale of gold and silver by banks (*Guoshuifa* (1993) 154);

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- the production and issue of stamp products for stamp collections and for sale by units and individuals other than the Ministry of Post and Telecommunication (*Caishuizi* (1994) 26);
- the sale of articles for pawn and the sale of consignment goods on behalf of a consignor (*Guoshuifa* (1993) 154);
- the issuance of newspapers and journals by units and individuals other than Post Units (*Caishuizi* (1994) 26);
- the production and distribution of silver contained in concentrated silver mines or other concentrated non-ferrous metal mines, medium refinery products and finished silver products (*Guoshuifa* (2000) 51);
- the fees charged by electric power enterprises on electricity generation enterprises to enter the power grid (*Guoshuihan* (2004) 607); and
- transportation, postal services, telecommunications services and certain modern services which are included in the VAT pilot programme (*Caishui* (2013) 106; *Caishui* (2014) 43); see ¶13-1030 for more details.

Deemed "sales of goods"

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

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

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Chapter 18

Customs

INTRODUCTION

General overview ¶18-010
Customs duty rate ¶18-110

CLASSIFICATION

Classification ¶18-210

CUSTOMS VALUATION

Introduction of customs valuation ¶18-310
Customs valuation methods ¶18-320
Customs valuation procedures ¶18-330
Customs valuation and transfer pricing ¶18-340
Royalty issues ¶18-350
Bonded goods sold in domestic market ¶18-360

PROCESSING TRADE RELIEF

General introduction ¶18-410
Customs implications ¶18-420
Unit consumption ¶18-430
Outward processing ¶18-440
Compliance issues ¶18-450

COUNTRY OF ORIGIN

General introduction ¶18-510
CoO rules ¶18-520
Direct consignment ¶18-530
Advance rulings ¶18-540

FREE TRADE AGREEMENTS

General introduction ¶18-610
Free Trade Agreements in China ¶18-620

CUSTOMS COMPLIANCE RATING

Customs compliance rating ¶18-710

BONDED FACILITIES/BONDED AREAS

Bonded facilities/bonded areas ¶18-810
Special customs supervision facilities and areas/locations ¶18-820

http://www.pbookshop.com

Foreign exchange policies .... ¶18-830
China (Shanghai) Pilot Free Trade Zone .... ¶18-840

TEMPORARY IMPORT AND EXPORT

Temporary import/export .... ¶18-910

CUSTOMS DUTIES RELIEF

Customs duties relief .... ¶18-1010
Customs administration on goods eligible for duty relief .... ¶18-1020

IMPORT/EXPORT CONTROL

Import/export licence control .... ¶18-1110
Import/export inspection and quarantine .... ¶18-1120

INTRODUCTION

¶18-010 General overview

Overview of China Customs

Under the *Customs Law of the People's Republic of China*, the PRC Customs Authority (interchangeably, "China Customs" or "Customs") undertakes to exercise border controls over all means of transport, goods, luggage and postal items; collect customs duties and other taxes and fees; investigate and suppress smuggling activities; and compile customs statistics.

There are three tiers of authority within the Customs hierarchy:

- General Administration of Customs (GAC). The GAC is the highest tier within the Customs Authority with responsibility for overall management and supervision of the Customs affairs throughout China. It reports directly to the State Council;
- regional Customs which report directly to the GAC; and
- local Customs offices, that are established in all ports, and most major cities, which report directly to the Regional Customs authority.

Customs declaration

The consignee or the consignor of the goods to be imported or exported who are registered with Customs or their engaged brokers that have been registered with Customs shall declare with Customs imports and exports within the following timeline:

- for the import declaration: within fourteen days when the means of transport are declared for entering into PRC Customs territory; and

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- for the export declaration: after the goods arriving at the Customs supervision area and 24 hours before the loading of the goods.

The import or export information declared to Customs should be authentic and accurate, including commodity description of the imported/exported goods, classification codes, specification and type, value, freight and insurance, other relevant expenses, country of origin (CoO) and quantity, etc. For those goods that are restricted from import or export, the import or export licences shall also be submitted to Customs before clearing the said goods from Customs.

GAC introduced a pilot programme since 1 August 2012 for a "paperless Customs clearance process." Paperless Customs clearance is a process under which Customs declaration information can be provided electronically (rather than both electronically and on paper), and the review by Customs is automated (rather than through physical examination of paper documents). The process is based on the compliance management of companies and a risk analysis conducted by Customs. The paperless programme is expected to reduce administrative burdens on import/export companies and expedite Customs clearance, thereby improving the efficiency of Customs. When the pilot programme was initiated, it was only applied in twelve Customs districts and for some activates. In accordance with *Bulletin of the* GAC (2014) 25, GAC extended the pilot programme nationally effective from 1 April 2014 such that:

- the pilot scope is expanded to Customs-related activities;
- transit of goods between different Customs offices is also covered in the pilot programme;
- the pilot programme also covers Customs declarations filed with, and approved by, the Customs office at the location where the company is registered, while the goods are imported at the port in the charge of another Customs office; and
- the pilot programme is to be launched in the Customs clearance of goods transported by means of courier or post.

Import/export tax

China Customs imposes import customs duty (CD) on imports into China, and export CD on a few of goods exported from China.

The CD is generally calculated by *ad valorem* and in a few cases, calculated by quantity, or by any other means as stipulated by the State. The formulas for the CD calculation are:

- CD payable (by *ad valorem*) = Dutiable value × Duty rate (see ¶18-110 for the duty rate)
- CD payable (by quantity) = Quantity of the goods × Duty amount per unit

In addition to the CD, Customs will also collect other taxes associated with the import for tax authorities, such as value-added tax (VAT) (see ¶13-370

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and consumption tax (the consumption tax is applicable for some types of goods such as wines, cosmetics, and cigarettes, etc., according to the domestic tax rules). The consignee of the imported goods and the consignor of the exported goods are the taxpayers, and they shall pay the CD and other import tax to designated bank within fifteen days after Customs issues the tax payment notice.

The import/export tax can be reduced or exempted in accordance with the provisions set out in the relevant regulations by the State Council on certain goods imported into or exported out of the designated areas, by the designated enterprises, or for designated uses.

¶18-110 Customs duty rate

Import duty rate

Import duty rate is mainly decided by the tariff code (see ¶18-210) of the goods to be imported. The CoO of the goods (see ¶18-510) is also a deciding factor of the applicable import duty rate which categorises the import duty rate into the following categories:

- The general tariff rates

  The general tariff rates shall apply to goods originating in countries or regions with which China has concluded no agreements for reciprocal tariff preference, goods with non-origin or no definite origin.

- The most favoured nation (MFN) tariff rate

  The MFN tariff rates shall apply to goods originating in signatory states of the World Trade Organisation (WTO), provided that the MFN treatment is reciprocal between China and these members; or those countries or regions with which China has concluded bilateral agreements for reciprocal MFN treatment or the customs territory of China.

  The MFN tariff rates are lower than the general tariff rates.

- The conventional tariff rates

  The conventional tariff rates shall apply to goods imported from and originating in the countries or regions which have regional trade agreements (see ¶18-610) with China for tariff preferences.

  The conventional tariff rates are lower than the MFN tariff rates.

- The special preferential tariff rates

  The special preferential tariff rates shall apply to goods imported from and originating in those less-developed countries or regions that have concluded special tariff preferential agreement with China.

  The special preferential tariff rates are lower than the MFN tariff rates.

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Note: Currently, the special preferential tariff rates are applicable to some goods imported from and originating in the Kingdom of Cambodia, the Lao People's Democratic Republic, the Union of Myanmar, the People's Republic of Bangladesh, the Republic of Angola, the Republic of Senegal, the Republic of Benin, the Republic of Burundi, the Central African Republic, the Union of Comoros, the Democratic Republic of Congo, the Republic of Djibouti, the State of Eritrea, the Federal Democratic Republic of Ethiopia, the Republic of Guinea, the Republic of Guinea–Bissau, the Kingdom of Lesotho, the Republic of Liberia, the Republic of Madagascar, the Republic of Mali, the Islamic Republic of Mauritania, the Republic of Mozambique, the Federal Democratic Republic of Nepal, the Republic of Niger, the Republic of Rwanda, the Republic of Sierra Leone, the Republic of Sudan, the United Republic of Tanzania, the Republic of Togo, the Republic of Uganda, the Republic of Zambia, the Republic of Equatorial Guinea, the Republic of Chad, the Federal Republic of Somalia, the Republic of Malawi, the Republic of Yemen, the Islamic Republic of Afghanistan, the Independent State of Samoa, the Republic of Vanuatu, and the Democratic Republic of Timor-Leste.

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Export duty rate

There are also export duties on a few export goods and the duty rates are decided by the HS codes of the goods.

The interim tariff rates

China Customs will set interim import and export duty rates on some goods for the purpose of encouraging the import of these goods or restricting the export. Hence, interim duty rates are generally lower than MFN duty rates or higher than any normal export duty rates that apply.

Currently, there are more than 767 tariff codes covered by the interim import duty rates (*Shuiweihui* (2013) 36). Export duty or interim export duty, ranging from 0% to 40%, is now imposed on 352 items, most of which are energy consuming, heavily polluting or resource intensive goods, such as coal, crude oil, fertilizer, nonferrous metal, etc.

The interim import tariff rates have the priority over the MFN tariff rates for application. Goods eligible for interim import tariff rates, when imported under the conventional tariff rates or special preferential tariff rates, will be levied under the lower of the two rates. The goods that are subject to the general import tariff rates are not applicable to the interim import tariff rates.

The interim export tariff rates have the priority over the export tariff rates for application.

Interim tariff rates are effective for a certain period specified by the State Council.

Chapter 19

Transfer Pricing — Rules, Concepts and Methods

TRANSFER PRICING — RULES, CONCEPTS AND METHODS

General overview .... ¶19-100
Laws and regulations .... ¶19-200
Impact of OECD BEPS project .... ¶19-300

BASIC CONCEPT

Associated enterprises .... ¶19-310
Arm's length principle .... ¶19-320
Comparability of data .... ¶19-325
Inter-quartile range .... ¶19-330
Capital adjustments .... ¶19-340
Location-specific advantages .... ¶19-345
Types of related party transactions .... ¶19-400
Focus on intangible transactions .... ¶19-405
Focus on service transactions .... ¶19-410

FUNCTION AND RISK — CHARACTERISATION OF ENTERPRISES

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

METHODOLOGIES OF TRANSFER PRICING

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

TRANSFER PRICING CONTEMPORANEOUS DOCUMENTATION

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

TRANSFER PRICING INVESTIGATION AND AUDIT

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

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ADVANCE PRICING AGREEMENTS (APAS)

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

TRANSFER PRICING — RULES, CONCEPTS AND METHODS

¶19-100 General overview

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

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

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

¶19-200 Laws and regulations

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

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

The *Implementation Regulations for Special Tax Adjustments* (Trial) (*Guoshuifa* (2009) 2, commonly referred to as "*Circular 2*"), released in January 2009,

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provides the much needed detailed guidance on a number of transfer pricing and other issues and is retrospective to transactions from 1 January 2008. Following the promulgation of *Circular 2*, other important circulars which impact China's transfer pricing regime have been introduced. These often have retrospective effect to cover transactions from 1 January 2008.

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

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

It is understood that the State Administration of Taxation (SAT) is currently amending *Circular 2* and plans to release the amended rules early 2015 in order to reflect the transfer pricing position and practices the tax authorities have applied so far and also to reflect domestic actions on Base Erosion and Profit Shifting (BEPS) actions suggested by the Organisation for Economic Co-operation and Development (OECD).

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

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

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

¶19-300 Impact of OECD BEPS project

In February 2013, the OECD announced a project to review BEPS. The purpose of the review was to establish why multinational profits were earning taxable profits in locations different from where their business activities took place. Although China is not an OECD member, it is involved in the BEPS project as an Associate due to its G20 membership.

Several of the action points under the project relate to transfer pricing:

- Action 8 – Assure that transfer pricing outcomes are in line with value creation: intangibles;
- Action 9 – Assure that transfer pricing outcomes are in line with value creation: risk and capital;
- Action 10 – Assure that transfer pricing outcomes are in line with value creation: other high-risk transactions; and
- Action 13 – Re-examine transfer pricing documentation.

The OECD has already received several discussion drafts regarding Actions 8 and 13, and expects to reach conclusions on all of the action points by September 2015.

China's tax authorities have been involved in the BEPS discussions, although no formal policies have been issued in response to the drafts issued by the OECD. Many of the changes being proposed are similar to the positions that China has previously taken, although it is not clear whether all of these will be included in the final recommendations of the OECD. It is likely that at least some of the conclusions of the BEPS project will impact transfer pricing policy and practice in China.

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BASIC CONCEPT

¶19-310 Associated enterprises

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

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

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

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

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

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

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

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