

China

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1.0 OVERVIEW

Chinese tax burden has been one of the key issues taken into account by foreign taxpayers when doing business in China¹ directly or through their Chinese subsidiaries. Among the 19 different Chinese taxes, those most commonly arising from foreign taxpayers' business operations in the nation are enterprise income tax (EIT), individual income tax (IIT), value-added tax (VAT), urban maintenance and construction tax and stamp duty.

As a general principle, residents of China are taxed on worldwide income and non-residents are taxed on Chinese-sourced income. Enterprises and individuals are regulated by the EIT law and IIT law, respectively, in respect of income taxation.

An enterprise is resident in China for EIT purposes if it is incorporated in China, or if it is incorporated outside China but the effective management is in China. A foreign enterprise is considered to have effective management in China if its production and business operations, personnel, accounting and property are all substantially managed and controlled in China. The normal EIT rate is 25% for resident enterprises. The normal withholding EIT rate for non-resident enterprises is 10% for income from a Chinese source, including dividends, interest, royalties and capital gains.

As of January 1, 2019, an individual is resident in China for IIT purposes if he or she is domiciled in China or if he or she is not domiciled in

China but stays in the country for 183 days or more in a calendar year. Otherwise the individual is non-resident. IIT rates for wages and salaries range from 3% to 45% on a progressive basis.

2.0 LEGAL SYSTEM

The national legal system in China consists of laws enacted by the National People's Congress (NPC) and its Standing Committee, administrative regulations issued by the State Council (executive branch), administrative rulings and other formulated documents issued by national agencies. The national legal system applies nationwide. Local government bodies may issue local regulations, rulings and other formulated documents for implementation in their location, which may not conflict with the national legal system.

In general, Chinese tax laws enacted by the NPC and its Standing Committee contain general principles, whereas the State Council issues administrative regulations for the implementation of the law. In addition, the State Council's departments—the Ministry of Finance and the State Administration of Taxation (SAT)—are in charge of finance and taxation and issue tax rulings, circulars, public notices and other formulated documents. In practice, local government authorities may issue interpretative and administrative tax documents for implementation in their own scope of administration.

3.0 TAXATION AUTHORITIES

The SAT manages Chinese tax collection and administration. The SAT administers provincial-level

tax bureaus, which in turn govern city-level tax bureaus, and district-level tax bureaus. District-level tax bureaus may maintain necessary tax offices in different locations within their districts.

4.0 BUSINESS VEHICLES

The most common forms of business vehicles for foreign investors to carry on business activities in China include wholly foreign-owned enterprises (WFOEs), Chinese-foreign equity joint ventures (EJVs) and Chinese-foreign cooperative joint ventures (CJVs). Collectively, WFOEs, EJVs and CJVs are known as foreign investment enterprises (FIEs).

4.1 Wholly foreign-owned enterprises

A WFOE is a Chinese legal entity incorporated by only foreign investors. In practice, a WFOE is generally a limited liability company, and each shareholder's liability is limited to the amount of the capital of the WFOE subscribed by the shareholder.

A WFOE is a separate legal entity liable to pay EIT and all other taxes in China in accordance with Chinese tax laws and regulations. It cannot be elected to be treated as a look-through entity for Chinese tax purposes. A WFOE's employees are liable to Chinese IIT in accordance with Chinese IIT law and regulations.

4.2 Chinese-foreign equity joint ventures

An EJV is a limited liability company incorporated under the laws of China by at least one Chinese shareholder and at least one foreign shareholder. Generally, the

¹ The term "China" excludes Hong Kong, Macao and Taiwan for Chinese tax purposes.

amount of shares held by foreign shareholders in an EJV must be at least 25% of the total EJV shares. The profits and losses of an EJV are shared proportionately between or among the EJV's shareholders in accordance with their respective ownership interest in the EJV.

An EJV is liable to pay various taxes in China in accordance with Chinese tax laws and regulations, and its employees are liable for Chinese IIT in accordance with Chinese IIT law and regulations.

4.3 Chinese-foreign cooperative joint ventures

A CJV is a legal structure incorporated under the laws of China by both Chinese and foreign parties. This legal structure allows considerable flexibility for Chinese and foreign parties to determine the cooperative conditions, the distributions of profits or products, the sharing of risks or losses, the management structure and the distribution of CJV property at the end of the cooperation. This flexibility stems from the CJV's governing document, the CJV contract.

A CJV is a limited liability company unless it takes another form of liability as approved by government authorities. The income tax consequence may vary depending on the legal structure.

4.4 Foreign investment holding companies

Many multinational companies have established foreign investment holding companies (FIHCs) in China to hold and manage their Chinese subsidiaries. This holding structure helps manage Chinese

taxation and cash flows of Chinese subsidiaries. An FIHC is either a WFOE or an EJV, depending on the ownership structure. To apply for incorporation of an FIHC, a foreign investor must have good credit and at least US\$400 million in total assets during the last year prior to the application, and must have incorporated an FIE in China with the actual paid-in capital of more than US\$10 million; or the foreigner investor must have good credit and must have incorporated at least 10 FIEs in China with the actual paid-in capital of more than US\$30 million. If the foreign investor incorporates an FIHC with a Chinese investor in the form of joint venture, the Chinese investor must have good credit and at least CNY 100 million in total assets during the last year prior to the application.

4.5 Partnerships

Since March 1, 2010, foreign enterprises and individuals have been permitted to set up foreign investment partnerships (FIPs) in China. An FIP in China must have at least two or more foreign partners, or at least one foreign partner and one Chinese partner. A partnership set up in China, including an FIP, is a look-through entity for income tax purposes, meaning that the partnership does not pay income tax in China. Rather, the partners of the partnership are subject to income taxes on their distributive share of the business profits earned by the partnership. In practice, an FIP is generally treated as a permanent establishment of foreign corporate partners for income tax purposes. Although it is a pass-through entity and is not subject

to income taxes, a partnership in China is liable to other taxes such as VAT, urban maintenance and construction tax and stamp duty.

4.6 Branches

Subject to approval from Chinese government authorities, a foreign enterprise may set up one or more branches in China. A branch may carry out business activities stated in its business license. A branch of a foreign enterprise is a legal entity but does not have legal personhood status in China, meaning the foreign enterprise is liable for any of the branch's debts.

In general, a branch of a foreign enterprise is a permanent establishment in the context of China's income tax treaties and arrangements, meaning the foreign enterprise is subject to EIT in China on business profits attributable to the permanent establishment.

4.7 Representative offices

A foreign enterprise may set up one or more representative offices in China to conduct permissible activities in China. The permissible activities are generally limited to market research, exhibition, promotional activities and liaising with the foreign enterprise's sale of products, provision of services, purchases from China or investments in China.

A representative office of a foreign enterprise does not have legal personhood status in China. It generally constitutes a permanent establishment of the foreign enterprise for Chinese income tax purposes. This means that the foreign enterprise is generally liable to EIT in China on

business profits attributable to that permanent establishment.

5.0 FINANCING A CORPORATE SUBSIDIARY

5.1 Equity financing

A foreign investor may contribute capital to an FIE in exchange for shares in the FIE. Equity investments in excess of the subscribed capital may be treated as capital surplus in the hands of the FIE. The FIE does not pay income tax on the receipt of equity investments.

In the case of windup of an FIE, the FIE's statutory reserves and retained earnings will be treated as dividends subject to withholding tax in China. The distribution of paid-up capital to the foreign investors will not be subject to withholding tax in China to the extent that the amount of distribution does not exceed the original investment cost. In practice, if the equity investments were injected in any currency other than Chinese currency, distribution of paid-up capital to foreign investors at the time of windup may result in capital gain or loss because of the difference between the foreign exchange rates at the time of initial investment and distribution.

5.2 Debt financing

FIEs are subject to registration, restriction and other regulatory requirements on borrowing of foreign funds. FIEs are not subject to income tax liability when borrowing and repaying debts. Foreign lenders generally are subject to VAT and withholding tax on interest income from China.

FIEs paying interest to related parties are subject to thin capitalization rules in China.

Under the thin capitalization rules, an FIE is allowed to deduct interest expenses actually paid to related parties up to the amount calculated on the basis of a standard debt-to-equity ratio (5:1 for financial enterprises and 2:1 for other enterprises) and other limitations of the EIT law and its implementation regulations. There is an exception if the FIE satisfies conditions that exempt it from the debt-to-equity limitation. Interest expenses in excess of the limitation are not deductible, unless special transfer pricing documentation is prepared.

5.3 Stamp tax

An FIE is subject to stamp duty at 0.05% of equity investments (paid-up capital and capital surplus) received from shareholders and 0.005% of the amount of the borrowed funds stated in loan agreements if the loans were made from financial institutions.

6.0 ENTERPRISE INCOME TAX

A resident enterprise is subject to EIT in China on worldwide income. A non-resident enterprise with an establishment or business site in China is subject to EIT in China on Chinese-source income and on overseas income that is effectively connected with that establishment or business site.

A non-resident enterprise is subject to EIT in China on a withholding basis in respect of dividends, interest, royalties, capital gains and "other income" if it does not have an establishment or business site in China, or if income is not effectively connected with that establishment or business site in China.

6.1 Income tax rate

The EIT rate is normally 25%. It is reduced to 20% for qualifying small-sized enterprises and to 15% for qualifying new high-technology enterprises. The withholding tax rate is statutorily 20% and reduced to 10% in all cases under domestic law. A lower withholding tax rate offered by an applicable income tax treaty or arrangement will prevail over the domestic 10% rate if the conditions for the lower rate are satisfied.

6.2 Capital gains

Capital gains derived by a resident enterprise or a non-resident enterprise with an establishment or business site in China will be included in the enterprise's taxable income and taxed in the same manner as ordinary income.

Chinese-source capital gains derived by a non-resident enterprise without an establishment or business site in China will be taxed separately at 10% on a withholding basis. Gains from the sale of immovable property is sourced to the place the immovable property is located. Gains from the sale of movable property other than inventory is sourced to the place of the enterprise, establishment or business site selling the movable property. Gains from the transfer of an equity interest in an enterprise is sourced to the place of the enterprise.

6.3 Branch profit tax

There is no branch profit tax in China, so a non-resident enterprise does not trigger EIT on after-tax profits earned by its permanent establishment in China, such as a branch or a representative office.



6.4 Computation of taxable income

6.4.1 Taxable base

The taxable base for a resident enterprise or a non-resident enterprise with an establishment or business site in China is taxable income. Taxable income equals gross income less non-taxable income, tax-exempt income, various deductions and net operating loss (NOL) carried over from previous years. Gross income comes from various sources, in cash or non-cash form, including income from sale of goods, income from provision of services, dividends, interest, royalties, rent, capital gains, donations and other income.

6.4.2 Deductions

In general, all costs, expenses, taxes, losses and other payments incurred by an enterprise are deductible to the extent of reasonableness and direct relevance to that enterprise's income. In general, a payment is reasonable if it is necessary and normal in the regular course of

business operations. Generally, NOL incurred by an enterprise in a taxation year can be carried forward for a maximum of five years. As of January 1, 2018, the five-year limit has been extended to 10 years for new high-technology enterprises and for small and medium-sized scientific enterprises. Losses cannot be carried back.

6.5 Income tax reporting

In general, EIT returns are filed on a quarterly or monthly basis within 15 days after the end of the current quarter or month. Annual EIT returns are filed within five months following the end of the current tax year. In general, a tax year is a calendar year.

A resident enterprise with one or more branches will calculate EIT and file EIT returns by combining the taxable income of its branches' taxable income. Two or more resident enterprises cannot file consolidated EIT returns, unless otherwise provided.

If a non-resident enterprise derives income subject to withholding tax, the payer of the income will be the withholding agent and liable to withhold EIT from payment at the time the payment is made or due, and to pay the EIT to the tax authorities within seven days following the date of withholding.

7.0 CROSS-BORDER PAYMENTS

7.1 Transfer pricing

China's transfer pricing regime requires that an enterprise comply with the arm's length principle in making transactions with related parties. Failure to do so can enable tax authorities to make reasonable tax adjustments to the transactions. The statute of limitation for transfer pricing adjustments is 10 years commencing from the tax year in which the transaction occurs. Tax authorities, when making transfer pricing investigation into an enterprise, may look back 10 years at the enterprise's past transactions.

7.2 Withholding tax on passive income

Dividends, interest, royalties and capital gains derived from a Chinese source by a non-resident enterprise without an establishment or business site in China is subject to EIT on a withholding basis at the normal 10% rate (or a lower rate offered by an applicable income tax treaty or arrangement). Dividends are sourced to the place of the enterprise paying the dividends. Interest or royalties are sourced to the place of the enterprise, establishment or business site bearing or paying the interest or royalties. If the person paying the interest or royalties is an individual, it is sourced to their place of residence.

7.3 Withholding tax on services fees

EIT on service fees derived by a non-resident enterprise is 25% of business profits attributable to an establishment or business site (or a permanent establishment in the context of an applicable income tax treaty or arrangement) in China. If the service activities do not constitute a permanent establishment in China, there should be no EIT liability.

In practice, a deemed profit rate is usually applied to determine the taxable profits. In general, the deemed profit rate is 15% to 30% for construction projects and design and consulting services, 30% to 50% for management services and at least 15% for all other services.

8.0 PAYROLL TAXES

8.1 Individual income tax

Employees working in China are subject to IIT on wages and salaries paid and borne by their Chinese employers. The IIT rates for wages

and salaries range from 3% to 45% on a progressive basis, depending on the amount of taxable income earned by an employee. As of January 1, 2019, the IIT on wages and salaries for resident individuals depends ultimately on their annual income under the new IIT law, whereas IIT on wages and salaries for non-resident individuals depends on their monthly income. Chinese employers are liable to deduct IIT from total wages and salaries and to pay the IIT to tax authorities within 15 days following the end of the current month.

8.2 Social Insurance and housing funds

Chinese employers and employees are liable to pay social insurance and housing funds. The social insurance contributed by employers consists of basic retirement insurance, basic medical insurance, injury insurance, unemployment insurance and maternity insurance. Generally, the social insurance and housing funds are calculated by a fee base multiplied by fee rates. The fee base is generally the employee's monthly salary, but it cannot be outside the range of 60% to 300% of the average salaries of workers in the same city in the last year. The fee rates vary from location to location. The total amount of all the social insurance and housing funds contributed by employers in some cities are more than 40% of employee wages and salaries.

9.0 INDIRECT TAXES

9.1 Value-added tax

A domestic entity or individual is subject to VAT on the sale or import of goods (tangible, movable property), the processing and repair of goods, the sale of intangible

property and immovable property and the provision of services in China, unless otherwise exempted.

China's VAT regime taxes both Chinese and foreign entities, as well as individuals, on stipulated sales or services. VAT represents a substantial part of tax revenue in China. Taxpayers subject to VAT, consumption tax or both also pay urban maintenance and construction tax, as well as education surcharge and local education surcharge, which are discussed in greater detail below.

As of May 1, 2018, the applicable VAT rates are 16% (previously 17%), 10% (previously 11%), 6% and 0%, depending on the type of transaction. The 16% rate covers the sale, import, processing or repair of goods (other than those subject to the 10% rate or 0% VAT) and the lease of tangible, movable property. The 10% rate covers the sale or import of special goods (generally those related to life necessity, such as agricultural products), transportation service, postal service, fundamental telecommunications service, construction service, the lease of immovable property and the transfer of land-use rights. Unless otherwise stipulated, exported goods and services qualify for a 0% VAT. In general, qualifying Chinese taxpayers are exempt from VAT on exported goods or services and may receive a VAT refund or credit under some circumstances.

Taxpayers paying VAT are separated into general VAT payers and small-scale VAT payers. In general, VAT paid by general VAT payers for their purchases of taxable goods or services (input VAT) is creditable

against the VAT arising from their sales of taxable goods or their provision of taxable services (output VAT). Thus, a general VAT payer calculates its VAT liability by subtracting input VAT from output VAT. Small-scale VAT payers may not claim any input VAT as a credit, and their VAT liability is generally determined by the gross amount from taxable transactions (excluding VAT) multiplied by a simplified VAT collection rate of 3% (or another applicable simplified collection rate).

The taxable period for VAT is one day, three days, five days, 10 days, 15 days, one month or one quarter, as determined by the competent tax authorities based on the amount of the VAT payable. Taxpayers that cannot pay VAT within a fixed taxable period may pay the VAT by each event. Taxpayers subject to a taxable period of one month or one quarter will file a VAT return within 15 days after the end of the month or quarter. Taxpayers subject to a taxable period of less than one month will prepay VAT within five days following the end of each taxable period, and will file VAT returns and settle the VAT for a given month within 15 days following the end of that month. Taxpayers importing taxable goods will pay VAT within 15 days following the date of the VAT payment notice issued by customs authorities.

9.2 Consumption tax

An entity or individual is subject to consumption tax in China on the import, manufacture, consignment processing or sale of taxable consumer goods, unless otherwise provided.

Taxable consumer goods include cigarettes, wine and other

alcohol, cosmetics, precious jewelry, firecrackers and fireworks, refined oil, automobile tires, motorcycles, cars, golf equipment, luxury watches, yachts, wooden disposable chopsticks and wooden flooring. Consumption tax is calculated based on a percentage of taxable sale income, or a rate of volume of sale, or a combination of the two, depending on the type of taxable consumer goods.

Consistent with VAT, the taxable period for consumption tax is one day, three days, five days, 10 days, 15 days, one month or one quarter, as determined by the competent tax authorities based on the amount of the consumption tax payable. Taxpayers that cannot pay consumption tax by a fixed taxable period may pay the consumption tax by each event. Taxpayers subject to a taxable period of one month or one quarter will file a consumption tax return within 15 days after the end of the month or quarter. Taxpayers subject to a taxable period of less than one month will prepay consumption tax within five days following the end of each taxable period, and will file a consumption tax return and settle the consumption tax for a given month within 15 days following the end of that month. Taxpayers importing taxable consumer goods will pay consumption tax within 15 days following the date of the consumption tax payment notice issued by customs authorities.

9.3 Customs tax

Customs tax is imposed on imports and exports of permissible goods and personal-use items. The recipients of imported goods, the

senders of exported goods and the owners of personal-use items are the taxpayers of customs tax. Customs tax is governed by China's Customs Law, Regulations of Customs Tax and other rules.

The rates for import duties include most favored nation tariff rates, treaty tariff rates, preferential tariff rates, general tariff rates and tariff-quota rates, among others. Customs tax on exports is limited to some particular items such as some natural resources. Imports of goods into specific zones, by specific companies or for specific purposes may qualify for customs tax reduction or exemption.

10.0 OTHER TAXES

10.1 Urban maintenance and construction tax

Taxpayers paying VAT, consumption tax or both, are subject to urban maintenance and construction tax at 7%, 5% or 1% of the total payment of VAT and consumption tax, depending on their location. In addition, taxpayers pay an education surcharge of 3% of the total payment of VAT and consumption tax, and a local education surcharge of 2% of that total payment. The urban maintenance and construction tax, education surcharge and local education surcharge are paid at the time the VAT and consumption tax are paid.

10.2 Stamp duty

Stamp duty is imposed on taxable documents, certificates and licenses, but stamp duty rates are minimal. Generally, all entities and individuals are subject to stamp duty on the signing or receipt of taxable documents,

certificates and licenses in China. The general stamp duty rates are 0.005% to 0.1% of the contractual amount, depending on the type of taxable contract.

The following is a list of stamp duty rates for different types of documents:

- 0.005% for loan contracts with financial institutions
- 0.03% for sale and purchase contracts and technology contracts
- 0.1% for property lease contracts
- 0.05% of the amount stated in taxable documents for the transfer of property ownership, copyrights, trademark, patents and technical know-how
- 0.05% of paid-in capital and capital surplus for accounting books
- CNY 5 for each business account book, real estate property ownership certificate, business license, trademark registration certificate, patent certificate and land-use rights certificate.

In general, the stamp duty is due and paid when the taxable contracts are signed or when the certificates and licenses are received.

10.3 Land appreciation tax

Land appreciation tax is imposed on entities and individuals who derive income from the transfer of state-owned land-use rights, buildings and other things immovably attached to the land in China. The land appreciation tax is determined on a progressive basis at rates of 30%, 40%, 50% and 60%.

10.4 Deed tax

Deed tax is imposed on the transferee of land and buildings in China by any means such as transfer, purchase, donation and exchange. The deemed tax equals to a tax rate multiplied by the transactional price in the case of transfer or purchase, the market price in the case of donation, or the price difference of the exchanged land or buildings in the case of exchange. The deed tax rate is generally 3% to 5%, depending on location.

10.5 Real property tax

Real property tax is imposed on the owner of real property in China. Generally, the real property tax equals 1.2% of 70% to 90% of the original value of the real property. It is 12% of rental income if the real property is leased. Residential property is exempt from real property tax, unless it is leased or used for any other business purpose.

10.6 Urban and town land-use tax

Urban and town land-use tax is imposed on entities and individuals who use land in cities, counties, towns and industrial and mining zones in China. The tax is computed by multiplying the number of square meters of the used land by a tax rate. The tax rate varies depending on location.

10.7 Resource tax

Entities and individuals are subject to resource tax on exploitation of taxable mineral products (crude oil, natural gas, coal and ore) or on the production of salt (solid and liquid salt) in China. The resource

tax is computed by the amount of exploited or produced taxable products multiplied by a tax rate as follows:

- 5% to 10% of sale amount for crude oil and natural gas
- CNY 0.3 to CNY 20 per ton for coal
- CNY 0.4 to CNY 20 per ton for ore
- CNY 10 to CNY 60 per ton for solid salt; CNY 2 to CNY 10 per ton for liquid salt.

10.8 Environmental protection tax

Enterprises and other business operators are subject to environmental protection tax on the discharge of taxable pollutants (air pollutants, water pollutants, solid waste and noise) in the territory of China and other sea areas under the jurisdiction of China.

10.9 Other

Other taxes in China include tobacco tax, vehicle purchase tax, vehicle and vessel tax, vessel tonnage tax, farmland occupation tax and fixed-asset investment direction adjustment tax. The fixed-asset investment direction adjustment tax has been suspended since 2000.

As of May 1, 2016, the Chinese business tax has been replaced by VAT, and those items previously triggering business tax have been entirely incorporated in the VAT regime. China does not currently impose estate and gift taxes.