ARTICLES

The Coming of Age of Enterprise Taxation in China

NATALIE P STOIANOFF

This article commences with a brief historical overview of the taxation system in China and provides a context for the key elements relevant to foreign enterprises since the Open Door Policy. The unified taxation of domestic and foreign-owned business enterprises recognises the maturity of China's economy and the greater role that domestic enterprises are playing in the world economy and, consequently, the need to ensure competition is on a level footing. However, the primary concern of this article is to provide an analysis of the 'principles based' unified enterprise income tax regime that commenced operation on 1 January 2008 together with its implementing regulations. This analysis reinforces China's integration of western tax concepts albeit in a much simplified manner than most economically-developed regimes. However, the unified regime does pave the way for China to utilise the benefits of that unification to enable development of better wealth distribution throughout the nation and thereby enhance economic development.

This article also demonstrates that domestic businesses were at a disadvantage before this unification and that disadvantage led to behaviour that sought to circumvent the disadvantage by utilising the loopholes available between the Domestic and Foreign Enterprise tax rules. The article concludes that this reform is as much an attempt at ensuring competition is equal between domestic and foreign sectors of the Chinese economy as it is about dealing with tax avoidance. The introduction of specific and general anti-avoidance measures is evidence of this dual purpose. It is perhaps too early to judge the performance of this new regime, but once the grandfathering arrangements come to an end, the true impact of the unified Enterprise Income Tax Law will become apparent.

INTRODUCTION

The first decade of the century has seen some significant progress in establishing the People's Republic of China (China) as an economic power of global proportion. Key to that progress has been China's push toward membership of the World Trade Organisation (WTO), achieved in late 2001, and the ongoing structural and legal reforms that followed. Part of that progress is illustrated by China's use of the taxation regime as a tool of social and economic change. In the early days of the Republic, namely the Maoist era, the emphasis was on moving the means of production out of private hands and into the hands of the State. Then with the leadership of Deng Xiaoping came the 'Open Door Policy' enabling China to engage with the world and encourage foreign investment in order to develop a socialist market economy. Toward the end of the last decade, the focus has been upon bringing balance into the system. The decision to unify the domestic and foreign corporate/enterprise income tax systems is recognition that domestic business has come of age and the need to artificially encourage foreign investment is no longer a priority. Further, it is in keeping with China's responsibilities under the WTO Protocol on the Accession of the People's Republic of China[1] requiring conformity with GATT 1994, namely moving toward a neutral tax regime.

This article commences with a brief historical overview of the taxation system in China and provides a context for the key elements relevant to foreign enterprises since the Open Door Policy. The unified taxation of domestic and foreign owned business enterprises recognises the maturity of China's economy and the greater role that domestic enterprises are playing in the world economy and, consequently, the need to ensure competition is on a level footing.[2] However, the primary concern of this article is to provide an analysis of the 'principles-based' unified enterprise income tax regime that commenced operation on 1 January 2008 together with its implementing regulations. This analysis reinforces China's integration of western tax concepts albeit in a much-simplified manner than most economically-developed regimes. However, the unified regime does pave the way for China to utilise the benefits of that unification to enable development of better wealth distribution throughout the nation and thereby enhance economic development.

HISTORICAL OVERVIEW OF THE TAXATION SYSTEM IN CHINA

In the early stages of the planned economy of the Peoples' Republic of China, the taxation system was utilised as a mechanism to shift ownership of business and industry out of private hands and into State-owned Enterprises (SOEs).[3] This 'socialist transformation of ownership' resulted in the elimination of the private ownership of the means of production by applying the highest taxes against such private enterprises and taxing the State-owned enterprises the least.[4]

First, the Principal Rules for Implementation of the National Tax Administration were promulgated in January of 1950 and established a unified system of taxation with 14 categories of taxation in addition to the existing agricultural tax.[5] These taxes were a combination of property taxes, income taxes, consumption and sales taxes. Specifically they were the industrial and commercial business tax, the commodity or product tax, the deposit interest income tax, the salt tax and cotton tax, stamp duty, the transaction tax, real estate tax, land tax, slaughter tax, special consumption behaviour tax, vehicle and vessel licence tax, and two further taxes that were not implemented, namely, the employment income tax and the inheritance tax.[6]

Then in 1953, the tax system was simplified as the economy represented by SOEs grew resulting in further reform in 1958 with the number of taxes being rationalised to 11.[7] The Consolidated Industrial and Commercial Tax was the most significant and consolidated all turnover taxes. Meanwhile, the Industrial and Commercial Income Tax was also established, taxing collectively and individually-owned enterprises, marking the introduction of the first enterprise income tax.[9] SOEs continued to provide their profits to the State moving from the enterprise bonus system to the profit-contracting system enabling such enterprises to retain a proportion of their profits.[10] The bonus system was reintroduced during the Cultural Revolution as such retention of profits was considered to resemble capitalism too closely.[11]

The tax system was further simplified after the Cultural Revolution resulting in eight different taxes after the reforms of 1973.[12] Not only were the taxes consolidated and simplified but the collection mechanism was also simplified.[13] SOEs were only liable to pay the Industrial and Commercial Tax while collective enterprises were liable for both the Industrial and Commercial Tax and the Industrial and Commercial Income Tax.[14] Even so, the vast proportion of State revenue came from the SOEs prior to the economic reform of 1979.[15]

The beginning of the Open Door Policy in late 1978 represented the establishment of China's new socialist market economy. One part of that policy was focused on the opening up of China to the rest of the world while the other part sought to reform the economic system from within.[16] A major element of this process was the encouragement of foreign investment. The implications for the tax system were two-fold. First, if foreign investors are to carry on business in China they ought to be paying taxes on their profits in China.[17] Second, the foreign investment enterprises were to be managed autonomously and not form part of the centrally-planned economy; accordingly, a separate tax regime was necessary for such foreign investment.[18]

The period 1979 to 1993 saw significant change in the fiscal system in China. The economy was restructured to include privately-owned enterprises and collectively-owned enterprises in addition to the state-owned enterprises.[19] The state-owned enterprises progressively moved away from having to surrender their profits to the state to paying income taxes instead and retaining the balance of their profits for expansion and to better reward employees.[20] The surge in Chinese-foreign jointly owned enterprises required the adoption of taxation laws applicable to foreign entities and individuals and by 1993, there were 32 different taxes on commerce and industry. Ho divides these taxes into five groups: taxes applicable to foreign entities and individuals, turnover and resource taxes, domestic enterprises income taxes and domestic individual income taxes, and the 'catch-all' wealth and behaviour taxes.[21] Those taxes applicable to foreign investment enterprises initially corresponded with the different forms of enterprise. From 1980, the Chinese-Foreign Joint Venture Income Tax Law taxed the income of Chinese-Foreign Equity Joint Ventures, while from 1981, the Foreign Enterprises Income Tax Law taxed the income of Chinese-Foreign Co-operative Joint Ventures and Wholly Foreign-owned Enterprises.[22] These tax regimes provided the necessary preferential tax treatment to compensate for the poor investment infrastructure available to foreign investors during the early stages of the Open Door policy.[23] In addition, further preferential tax treatment was available to foreign investors according to their location, such as being in specially designated Special Economic Zones (SEZs), or the nature of industrial projects in which they were engaged.[24]

Foreign individuals earning income in China during this time were also subject to tax. The Individual Income Tax Law of 1980 dealt with foreign individuals working in China while the Individual Income Regulatory Tax Law applied to local Chinese from 1986. Meanwhile, turnover taxes still applied during this period. The Industrial and Commercial Tax remained in force until 1984 when it was split into two separate regimes. One regime was applicable to foreign investment enterprises and called the Consolidated Industrial and Commercial Tax while the other regime comprised a new suite of four separate taxes applicable to domestic enterprises. These new turnover taxes were the Value Added Tax, Product Tax, Business Tax and Resource Tax.

This period of over a decade from the time of opening up China's economy saw immense growth.[25] By 1993, the Chinese economy increased ten times, a rate not to be matched even in the significant wealth-producing period that followed.[26] Foreign direct investment steadily increased during the first decade but then exploded during the 1990s and into the current century.[27] It is at the beginning of the 1990s that the two tax regimes dealing with foreign enterprises were streamlined into a uniform system, the Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises 1991. This unified regime provided better certainty and stability to investors.

Then in 1994, a new taxation regime designed to implement 'new macroeconomic controls' came into effect. While the Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises of 1991 remained in force, the regime affecting domestic enterprises was streamlined into the Provisional Rules of People's Republic of China on Enterprise Income Tax and resulted in a lowering of the tax rate to equal that applied to foreign investment enterprises, namely 33 per cent comprising 30 per cent national tax and a 3 per cent local tax.[29] While this exemplified the need of the central government to take greater control of tax revenues in order to deal with the increasing disparity in wealth, infrastructure and services between the eastern provinces and the western provinces, the reality was that a revenue sharing formula was put into place effectively splitting the revenue raised 50:50 between the provincial and central governments.[30]

However, during this period, arguably the most significant reform was the restructuring of the turnover taxes into a regime applicable to both domestic and foreign enterprises alike.[31] These included a Value Added Tax, Business Tax and Consumption Tax with the 1984 Consolidated Industrial and Commercial Tax applicable to foreign entities and individuals being repealed. Simultaneously, the regime dealing with income tax levied on individuals was reformed covering domestic and foreign individuals and introducing a residency element to the criteria for determining individual tax liability.

Both the Ministry of Finance[32] and the State Administration of Taxation[33] (SAT) play their respective roles in developing taxation policy and administration in China. The SAT particularly has the role of drafting taxation laws and regulations and, in addition, is the primary 'operational unit for the administration and implementation of tax laws' in China.[34] Both organisations are empowered to interpret the laws and regulations including by issuing circulars, rulings and notices, however, this role tends to fall within the primary responsibility of SAT. [35] Sub-bureaus of SAT are found in the provinces, regions and cities and, together with the local tax bureaus, administer the tax laws including processing the tax returns and collecting taxes.[36] The SAT has a Commissioner and four Deputy Commissioners, a Chief Accountant and Chief Economist.[37] In addition, a Chief Supervisor is assigned by the CPC Central Committee for Discipline Inspection.[38] Such a structure is not unusual but rather illustrates the transplant of taxation regimes from China's western counterparts. Where the difference with China's western counterparts does lie is in the way the local offices operate and interact which, in the early days of the new socialist market economy, led to China's wealth concentrating in the eastern provinces that attracted greater foreign direct investment and leaving the western, more remote, provinces starved of infrastructure, services and capital. [39]

More than a decade later, China finally addressed the inequity of the divided enterprise income tax system by unifying the treatment of domestic and foreign owned enterprises under a residency and source-based income tax regime. This came after a relatively long consultation process and with the backdrop of the removal of the agricultural tax as part of 'China's drive to "build a new socialist countryside".[40] Part IV of this chapter provides an analysis of this unified system after Part III outlines the prior, and in most cases continuing, taxation regime applicable to foreign-owned enterprises in China.

TAXATION OF FOREIGN ENTERPRISES POST THE OPEN DOOR POLICY

With the opening up of the market in China in the late 1970s and the encouragement of foreign investment in that market, the taxation regime in China initially split in two: one levied in relation to foreign investment enterprises and foreign individuals and the other levied against domestic enterprises and Chinese individuals. By the mid-1990s a certain degree of rationalisation took place and established a regime that, for the most part, continues today. Much of the reform of the mid-1990s would have satisfied the requirements of transparency, equity and fair treatment, elements that were essential for any country hoping to accede to the World Trade Organisation. However, there remained a distinction between the income tax treatment of foreign investment enterprises and domestic enterprises. The following provides an outline of the taxes relevant to foreign investment enterprises.

As mentioned above, the reforms of 1994 saw the consolidation of individual income taxes, levied against the income of both Chinese citizens and foreigners, into one regime. Individuals domiciled or resident in China for at least one year have taxes levied against their salary and wages, business and other income from worldwide sources. Where the residency is less than one year only, income sourced in China is taxed.[41] Foreigners working in China for more than one year up to a maximum of five years can apply to SAT to have only their Chinese sourced income taxed in China.[42]

The Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises of 1991 applied to equity joint ventures, cooperative joint ventures and wholly foreign-owned enterprises, foreign companies with establishments in China and foreign companies without establishments in China but deriving income from sources in China: Art 3. While the tax rate comprised a 30 per cent national tax component and a three per cent local tax component (Art 10), a series of tax incentives in the form of tax holidays and reduced income tax rates (often 15 per cent) were available: Arts 7, 8 and 9. These incentives were either provided because the enterprise was located in a city or region targeted for development or the enterprise was engaged in an industry targeted for development. However, it was also common for such enterprises to be incurring losses in the early stages of operation. Accordingly, Art 11 permitted losses to be carried forward for a maximum of five years. New arms-length transfer pricing rules were also introduced by this regime: Art 13. Investigations, disputes and penalties are dealt with under the Administrative Law on Levying & Collection of Taxes of the People's Republic of China.

Significant incidents of tax evasion will invoke the operation of the criminal law and may result in prison sentences as well as large fines.

The turnover taxes during this period were the key revenue raisers. They were streamlined to apply to all businesses, foreign and domestic alike, and comprised the Value Added Tax (VAT), the Business Tax (BT) and the Consumption Tax (CT). VAT is levied on taxpayers engaged in the sale of goods, the provision of processing or repair and replacement services, or the importation of goods.[43] There are varying rates of tax depending on the nature of the goods or services. This system operates by crediting input taxes against output taxes. An input tax is paid by the taxpayer who receives taxable services or purchases goods. An output tax is the VAT payable by the taxpayer selling goods or taxable services.[44]

Business Tax is aimed at covering those activities not subject to VAT. It is imposed on business gross turnover of taxpayers engaged in the provision of taxable labour services, the sale of immovable properties and the assignment of intangible assets.[45] This is not a creditable tax and accordingly input taxes cannot be recovered.[46] The various tax rates applicable are levied on the full selling price of the items subject to this tax.[47] Consumption Tax, on the other hand, is levied on the manufacturers and importers of specific luxury or non-essential goods.[48] This is akin to excise taxes and is levied on 14 classes of taxable items and applies 18 different tax rates.[49] Ultimately, the tax payable by the manufacturer or importer of these goods is passed onto the consumer in the form of higher prices. It is calculated on the sales value or the sales volume of those goods. In addition to these turnover taxes, there are a number of other taxes applicable to foreign-owned enterprises including the land appreciation tax, stamp duties and customs duties, however, they will not be covered in this article.

These turnover taxes would have played a significant role in the taxing of foreign enterprises as the income taxes levied were often quite low due to the preferential treatments available as described above and the fact that these foreign enterprises were often operating at a loss. It must be remembered that the rationale for such preferential treatment was to encourage foreign direct investment and this was clearly achieved. However, the turnover taxes were less than ideal causing distortions in the economy, having a cascading effect and prejudicing service-based businesses and certain types of manufacturing businesses.[50] In addition, to take advantage of the preferential income tax treatment available to foreign enterprises, local business owners would engage in structuring their investments through offshore companies to invoke the application of the foreign enterprise tax regime.[51] Li and Krever point out that the impact of the combination of the inefficiencies of the turnover taxes and the discriminatory enterprise income taxes on the distribution of revenue in China exacerbated the disparity in wealth between the provinces.[52] This article will not be analysing the subsequent developments in the turnover taxes, rather, it will consider the reforms regarding enterprise income tax. The need for unification is made quite clear as the next section of the article explains. What is significant is the fact that the legislature has played a major role in the lead-up to the unification. Previously, as mentioned above, tax law was predominantly in the hands of the executive. The unification process engaged the legislature in a manner most western economies would recognise and resulted in tax legislation that exemplifies the national treatment expectations of all WTO members.

UNIFICATION OF THE CORPORATE OR ENTERPRISE TAXATION SYSTEMS

It was the Third Plenary Session of the Sixteenth Central Committee of the Communist Party of China that called for the unification of the income tax regime for all categories of enterprise.[53] Improving the socialist market economy was a key focus. This then led to the joint efforts of the Ministry of Finance, The State Administration of Taxation and the State Council Legislative Affairs Office in drafting the new Enterprise Income Tax Law which, in 2004, was provided to all levels of government for comment, and in relation to which roundtable discussions were had with relevant ministries, enterprises and experts.[54] Further comments were obtained from agencies and departments of the Central Government in 2006 before another draft was prepared and submitted to the Standing Committee of the National People's Congress on 28 September 2006.[55] After further deliberations and consultations, the final draft was delivered by the Minister of Finance at the Fifth Session of the Tenth National People's Congress on 8 March 2007. The Enterprise Income Tax Law of the People's Republic of China was promulgated on 16 May 2007 and became effective on 1 January 2008 (Enterprise Income Tax law).

In his delivery of the explanation of the final draft of the Enterprise Income Tax Law, the Minister of Finance noted the guidelines for the tax reform:

to establish a scientific and standardized enterprise income tax system uniformly applicable to various types of enterprises and create an environment for fair competition among all enterprises in accordance with the overall requirements of the Scientific Outlook on Development and for improving the socialist market economy by basing the tax reform on the principle of simplifying tax regimes, broadening tax base, lowering tax rates and strictly enforcing administration of tax collection, and by drawing on international experience in this regard.[56]

This has certainly been achieved with the Enterprise Income Tax Law as will become evident from the following analysis. Further the Minister points out six principles followed in the drafting of the new regime. The first deals with removing the differentiated tax burden between domestic and foreign-funded enterprises while the second is aimed at achieving sustainable development of the national economy.[57] The third recognises the utility of taxation as a regulatory instrument to encourage industrial development (for example through targeted preferential treatment), while the fourth recognises the importance of drawing upon international experience.[58] The fifth principle relates to rationalising distribution relations to effectively collect fiscal revenues (an issue identified above regarding the disparity of funding between the provinces) and the final principle deals with compliance and simplicity so that 'tax payment [is made] easier and costs to both the administrators and tax payers are reduced.[59]

Accordingly, the Chinese corporate taxation system came of age removing the differential tax treatment between foreign-owned and domestic enterprises from 1 January 2008. While individually-owned enterprises and partnership enterprises are specifically excluded from the operation of the new regime,[60] the Enterprise Income Tax Law does apply to 'enterprises and other organisations' ('Enterprises'): Art 1. This unification effectively removes the perceived 'unfair advantages for foreign enterprises over domestic enterprises'[61] by providing a more equitable and efficient system. In addition, it represents China's acknowledgement that in order to encourage foreign investment through foreign-owned enterprises special treatment over domestic enterprises is no longer required. This demonstrates recognition of the sophistication of the Chinese economy. However, the Enterprise Income Tax Law is a 'principles-based' law comprising only 60 articles requiring further detail for its implementation. Accordingly, the Implementation Rules of the Enterprise Income Tax Law of the People's Republic of China (the Implementing Regulations) was promulgated by the State Council on 6 December 2007 effective, also, on 1 January 2008. Following is an analysis of the principles of the Enterprise Income Tax Law.

A Jurisdiction to Tax

1 The taxpayer

Like most other income tax laws a distinction is made between resident and non-resident enterprises. A resident Enterprise is one that is either established under the laws of China or, if established under the laws of a foreign country, has its effective management located in China: Art 2. A non-resident Enterprise is one established under the laws of a foreign country and its management organisation is outside China but either has an establishment or place in China or, if it does not have such a place or establishment in China, derives income sourced from China: Art 2. The term 'management organisation' is akin to the taxation concept of effective management and control and is defined in Art 4 of the Implementing Regulations as organisations 'implementing substantive and comprehensive management and control over the production and business operations, staff, accounts and property etc of an enterprise'.

2 Residency and source

Article 3 of the Enterprise Income Tax Law identifies the type of income upon which tax will be levied. Resident Enterprises must pay tax on income derived from sources both inside and outside China. There is no surprise here. Non-resident Enterprises with an establishment or place in China must pay tax on income derived by that establishment from sources in China and on income sourced outside of China that is effectively connected with the establishment in China. The tax rate applicable to such Non-resident Enterprises and Resident Enterprises is 25 per cent: Art 4. In the case of Non-resident Enterprises with an establishment or place in China, but whose income is not effectively connected with such an establishment, only income derived from sources in China will attract tax and the rate of such tax will be 20 per cent: see Arts 3 and 4. Similarly, a Non-resident Enterprise with no establishment or place in China will pay tax at the rate of 20 per cent on income derived from sources in China: see Arts 3 and 4.

3 Analysis

While at first glance these provisions appear to be quite regular, it is important to note that the dual regime identified and taxed enterprises according to where they were established. Those established in China were taxed on their worldwide income while those established elsewhere were only taxed on their Chinese-sourced income. Earlier, the point was made that under the dual regime, a Chinese company could interpose a foreign company in its structure in order to fall within the Foreign Enterprise regime thereby attracting a different tax rate on its Chinese sourced income. Equally it could avoid tax altogether on its foreign-sourced income through the foreign interposed enterprise. Such arrangements were not unusual in the establishment of joint ventures offshore from where the worldwide distribution of products or the licensing of new technologies would occur at market prices after obtaining the same from the Chinese source at cost. In some way, the reclassification of residency to include foreign enterprises with effective management in China, together with the unified law's requirement that non-resident enterprises pay tax on income sourced outside of China that is effectively connected with the establishment in China might go some way to addressing the type of arrangements that the dual regime left untaxed. Clearly, this would require significant restructuring of corporate structures and contractual arrangements. However, the transfer pricing rules together with the introduction of controlled foreign corporation rules make further headway into addressing tax avoidance.

Arts 41 to 48 in Chapter 6 of the Enterprise Income Tax Law provide for new anti-avoidance measures including the basic operation of a transfer pricing regime (Arts 41–44). Article 41 stipulates the basic operation of the transfer pricing rules and these are further clarified in Arts 109–112 of the Implementing Regulations where the basic terms of 'interested party', 'independent transaction principle', and 'reasonable methods' are defined. An enterprise can propose transfer pricing principles and determination methodology for transactions with related bodies and enter an advanced pricing arrangement or agreement with the tax authorities: Art 42, Enterprise Income Tax Law. However, the enterprise must provide information regarding these transactions as an appendix to its annual income tax return (Art 43, Enterprise Income Tax Law) and failing that the relevant tax authority will have the power to deem the enterprise's taxable income in accordance with the laws and regulations: Art 44, Enterprise Income Tax Law. When the tax authority carries out an investigation pursuant to Art 43 of the Enterprise Income Tax Law, the Implementing Regulations at Art 114 describe the nature of the 'relevant information' that must be provided by the enterprise and its related enterprises. The extent of that information certainly doesn't leave much room for disguising the types of arrangements that might have avoided attracting Chinese income tax in the past.

Article 45 of the Enterprise Income Tax Law comprises the equivalent to a controlled foreign corporation (CFC) rule. This is truly evidence of China's increased sophistication in its taxation regime, albeit a rather rudimentary CFC regime. Further, it only targets controlled foreign enterprises in countries or regions with tax rates significantly/evidently lower than the tax rates in Art 4 of the Enterprise Income Tax Law. In essence, where the foreign enterprise is controlled by Chinese resident enterprises and/or individual Chinese residents, the profits of that foreign enterprise will be included in the taxable income of the resident controllers even if the profits are not distributed or are under-distributed. This regime also goes some way to addressing the opportunities for avoidance under the dual tax regime.

B Income and Deductions

1 *Taxable Income*

Taxable income is defined in Art 5 of the Enterprise Income Tax Law to comprise the gross income in a tax year less the non-taxable income, tax exempt income, deductions and allowable prior-year losses. In the case of foreign-owned enterprises, one needs to be able to distinguish between Chinese sourced and non-Chinese sourced income. Article 6 lists the types of monetary and non-monetary income that comprises the gross income, namely: income from the sales of goods, provision of services and transfer of property; dividends, bonuses and other equity investment income; interest; rent; royalties; donations and other income. Non-taxable income is defined in Art 7 of the *Enterprise Income Tax Law* to include government allocations, governmental administration charges and funds levied according to law and collected and managed as treasury management of the State (akin to businesses charging Goods and Services Tax and collecting that tax on behalf of government), and other non-taxable income specified by the State Council.

Article 19 determines the taxable income for non-resident Enterprises with no establishment or place in China and for Non-resident Enterprises with an establishment or place in China, but whose income is not effectively connected with such an establishment. In relation to equity investment income such as dividends and bonuses, and income from interest, rent and royalties the calculation method shall be in accordance with Gross Income (Art 6) whereas income from the transfer of property shall be calculated by reducing the Gross Income by the net value of the property transferred (Art 16, see below). All other income comprising Taxable Income is to be calculated by reference to these two methods.

2 *Deductions*

When calculating Taxable Income, Art 8 provides that a reasonable amount of expenditures actually incurred in the derivation of that income will be deductible, including costs, fees, taxes, losses and other expenditure. This is an example of harmonisation between domestic and foreign-owned enterprises. Under the previous regime, only foreign investment enterprises were able to claim what was actually incurred in relation to salaries and wages whereas a cap was applied for domestic enterprises. There still remains a cap for claims relating to charitable donation expenditure with Art 9 requiring a cap of 12 per cent of total annual profit to be applied.

Further, Arts 10 to 18 stipulate further restrictions on what can be deducted from Gross Income in order to calculate Taxable Income. Article 10 specifically excludes the following from deductibility: payments of dividends, bonuses and other returns on investment; the amount paid in Corporate Income Tax; tax surcharges; penalties, fines and losses through the confiscation of property; donations other than those specified in Art 9; sponsorship expenditure; provisions that have not been verified; all other expenditure that is not related to the generation of income. Depreciation of fixed assets is allowed as a deduction subject to various exclusions: Art 11. In relation to intangible assets, Art 12 allows amortisation to be deductible except in relation to the following intangible assets: expenditure related to self-developed intangible assets where such expenditure has already been deducted; self-developed goodwill; intangible assets not relevant to the operations of the Enterprise; and other intangible assets disallowed for amortisation and deduction. The amortisation of specific long-term deferred expenses is also allowed under Art 13, namely: reconstruction expenditures of fixed assets that have been fully depreciated and of leased-in fixed assets; expenditure incurred for the major repairs of fixed assets; and other expenditure to be amortized as long-term deferred expenses. The cost of investment assets are not deductible under Art 14 whereas the cost of inventory used or sold by the Enterprise is deductible under Art 15 according to specific rules, and the net book value of transferred assets may be deductible under Art 16. Losses incurred by the Enterprise in a tax year may be carried forward and offset against profits of following years for a maximum of five years: Art 18. However, in relation to consolidations, Art 17 provides that losses incurred by the overseas operating units of an Enterprise filing Corporate Income Tax will not be deductible against the profits of domestic operations.

The power to provide detailed rules relating to the scope and criteria of income and deductions and the tax treatment of assets rests with the Ministries of Finance and the State Administration of Taxation within the State Council: Art 20. Accordingly, the tax laws together with the administrative regulations of these authorities are to be followed when calculating Taxable Income where the corporate financial and accounting treatments differ from those tax laws and regulations: Art 21. What is important to note is that this new unified regime actually represents a unification and standardisation of deductions available to both domestic and foreign owned enterprises. Once again it brings both types of enterprises onto a level playing field as far as tax liability is concerned. But as for dealing with the potential to take advantage of the residence and source rules discussed above, namely refining the transfer pricing rules and introducing the controlled foreign corporation rule, the Enterprise Income Tax Law adds two more anti-avoidance provisions to its armoury.

3 *Anti-avoidance Provisions*

The anti-thin capitalisation rules together with a general anti-avoidance provision have been added to the suite of regimes designed to address previous losses of tax revenue.

Article 46 of the *Enterprise Income Tax Law* provides the anti-thin capitalisation rule. Where an interest expense is incurred by an enterprise due to related parties exceeding the specified debt to equity ratio for their investment in the enterprise, that enterprise will not be able to deduct the portion of the interest expense that corresponds to the exceeded ratio. Article 119 of the Implementation Regulations defines both direct and indirect 'debt securities investments' and 'equity investments' and empowers the finance and tax departments of the State Council to determine the specified debt to equity ratio. This attempt at an anti-thin capitalisation rule has been described as 'a step forward but possibly not a large enough one' by Dr Nolan Sharkey who points out that the regime does not take into account 'overall excessive debt funding' but rather is limited to a determination of related party debt, a mechanism abandoned by Australia, for instance, in 2001.[65] Nevertheless, this is an opportunity for China to learn the basic operation of such a regime before progressing to the more advanced one that engages with multi-national enterprise debt allocation.

A general anti-avoidance measure is provided at Art 47. Where an enterprise has entered into an arrangement that does not have a reasonable commercial purpose but results in a reduction of its gross income or taxable income, the tax authority will be able to make reasonable adjustments. Where adjustments to the taxable income of enterprises are made by the tax authorities in accordance with Chapter 6, interest will be applied against the additional tax payable as a result of that adjustment: Art 48. The interest rate is determined in accordance with Art 122 of the Implementation Rules of the *Enterprise Income Tax Law* of the People's Republic of China. This is an interesting addition to the *Enterprise Income Tax Law* when one recognises firstly the necessity of detailed rules together with the importance of case law in making such a provision work. The Implementing Regulations do not provide the necessary details rules and, with China being a civil law jurisdiction, judges are expected to apply the law rather than develop it.

C Tax Payable and Preferential Tax Treatment

The tax payable by an enterprise is calculated by multiplying the Taxable Income by the relevant tax rate and then reducing that amount by any tax reductions, exemptions or credits provided under the *Enterprise Income Tax Law*: Art 22. Such preferential tax treatment is provided in Arts 25 to 36. Meanwhile, Arts 23 and 24 provide for the nature of credits to be granted in relation to foreign income tax already paid.

There are still quite a number of activities and industries that attract preferential tax treatment under the unified regime. Article 25 provides the general statement that those industries and projects specifically supported or encouraged by the State will be granted preferential tax treatment. Specific investment income items are granted tax-exempt status under Art 26 as is the income derived by qualified not-for-profit organisations. In addition to the reductions/exemptions provided to non-tax resident enterprises, the Enterprise Income Tax may be reduced or exempted for enterprises earning income from agricultural, forestry, animal husbandry and fishery projects, from specified public infrastructure projects, from prescribed environmental protection, energy and water conservation projects and from prescribed transfer of technology: Art 27.

A reduced tax rate of 20 per cent is levied on small-scale enterprises that meet regulatory requirements while a reduced tax rate of 15 per cent applies to State-supported high technology or new technology enterprises: Art 28. Further, to the extent that the Enterprise Income Tax is allocated to local government, an autonomous government of an autonomous minority region may reduce or exempt such tax: Art 29.

Accelerated deductions, referred to as 'super deductions', are allowed under Art 30 for expenditure relating to research and development expenses and salaries paid to disabled and other staff whose employment is encouraged by the State. A specified percentage of investment in venture capital enterprises that have invested in State-encouraged industries can be deducted against Taxable Income: Art 31. A similar incentive is granted by Art 34 where an enterprise has invested in special equipment that either aids in environmental protection, water and energy conservation or enhances production safety. Meanwhile, shorter depreciation periods or accelerated depreciation may be applied against fixed asset investment where those assets pertain to technological advancements: Art 32. In addition, further deductions against Taxable Income may be available where the income of an enterprise is derived from the production of goods in respect of which State production policies have been followed including the comprehensive utilisation of resources: Art 33.

Article 35 provides the State Council with the power to formulate the detailed implementation rules in relation to the operation of these tax incentives. In Arts 82 to 102 of the Implementing Regulations, comprehensive details in relation to the operation of the tax incentives are provided. The State Council also has the power to develop tax incentive policies in accordance with economic and societal needs and must file those policies with the Standing Committee of the National People's Congress: Art 36 of the *Enterprise Income Tax Law*.

D Administration, Assessment and Collection

1 Administration of Assessment and Collection

In addition to the provisions of the *Enterprise Income Tax Law*, the administration and collection of enterprise income tax will be in accordance with the rules in the Tax Collection and Administration Law of the People's

Republic of China: Art 49. Resident Enterprises will be required to file their returns at the location of their registered address unless that address is located outside China in which case the return should be filed at the location of their actual management and control: Art 50. If there are a number of locations where the Resident Enterprise operates in China, in the form of business establishments without legal status, then income of each establishment will be combined and one return filed. Interestingly, enterprises are otherwise not permitted to consolidate for tax purposes.[66] The problem with this method, while trying to simplify the administrative burden of filing in each province of operation, is that the tax revenue collected will favour those local governments where the enterprise is registered. In section III of this article it was discussed that there is a sharing of revenue between the local government that collects the tax and the central government. This consolidation causes an imbalance in revenue distribution. However, with the local vs central sharing of revenue moving to 40:60, that does give the central government scope to distribute revenue to those provinces that lost out in the consolidation.

Article 51 deals with the filing of returns for Non-resident Enterprises. Non-resident Enterprises with an establishment in China that derives income from sources either in or out of China must file their tax returns at the location of their establishment. Non-resident Enterprises with an establishment or place in China, but whose income is not effectively connected with such an establishment, will pay tax at the location of their withholding agent. It is important to note that taxes must be paid in Renminbi and so if taxable income is earned in another currency it must first be converted to Renminbi and then taxed accordingly: Art 56.

The income tax year under this regime runs from 1 January to 31 December or part thereof where an enterprise starts or terminates operations or undergoes liquidation during the year: Art 53. Provisional tax payments are to be made on either a monthly or quarterly basis within 15 days of the end of each month or quarter: Art 54. The payments are to be accompanied by provisional tax returns with the final tax payment to be accompanied by the annual tax return to be lodged within five months after the end of the tax year. Where an enterprise terminates operations during an income year then it has 60 days from the date of that termination within which to settle its tax obligations: Art 55. Further, income from the enterprise's liquidation must first be paid accompanied by a further tax return prior to the cancellation of the enterprise's business registration.

2 *Withholding at Source*

Under Art 37, income derived by a Non-resident Enterprise from sources within China will be subject to withholding tax. The payer of the income will be acting as withholding agent and be required to withhold the required tax from the payments made or due. The payer, of engineering contracts or labour services provided by non-resident enterprises, may be designated by the tax authorities as the withholding agent: Art 38. Where the withholding agent fails to withhold the necessary tax at source, the non-resident enterprise taxpayer must pay the tax at the place where the income was derived: Art 39. If the taxpayer also fails to pay the tax, then the tax authorities have the power to collect the outstanding tax from other income payable to the taxpayer that is sourced in China: Art 39. It would seem that Art 39 anticipates potentially poor compliance with the withholding tax system, particularly when Art 40 requires that withholding tax payments must be made to Treasury and corresponding withholding tax returns filed with the local tax authority within seven days of each incident of withholding.

E Supplementary Provisions

Article 57 grants a five-year grandfathering period to enterprises that were approved to be established before the promulgation of the *Enterprise Income Tax Law* and which were entitled to reduced income tax rates under the previous laws and regulations. The result is that the preferential tax rate will be gradually increased to the tax rate prescribed in the *Enterprise Income Tax Law* over a five-year period and in accordance with the rules stipulated by the State Council. Further, those enterprises that enjoyed preferential tax treatment in the form of tax holidays over a specified period will be able to continue to benefit from such tax treatment until the end of that period. Where an enterprise is entitled to such a tax holiday but has yet to benefit from such a preferential tax treatment due to not yet achieving profitability, the tax holiday period will commence from 1 January 2008, that is, the date of effectiveness of the *Enterprise Income Tax Law*. Article 57 provides that similar grandfathering arrangements for new or high technology enterprises encouraged by the State and located in special zones for the promotion of foreign trade, economic and technological cooperation and other State Administered special zones, will be determined by the State Council. In addition, other enterprises within an encouraged industry category will be able to benefit from income tax reductions and exemptions according to the regulations of the State Council.

The remaining provisions of the *Enterprise Income Tax Law* deal with the operation and application of the law. The State Council has the power under Art 59 to formulate the implementation rules which, as indicated above, it has promulgated on 6 December 2007 effective, on 1 January 2008. As for any conflict with the provisions of a tax treaty or agreement concluded by the government of China with a foreign government, Art 58 provides that the provisions of the treaty or agreement will prevail over those of the *Enterprise Income Tax Law.* Finally, Art 60 repeals the *Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises* as well as the *Provisional Rules of People's Republic of China* *on Enterprise Income Tax* effective on 1 January 2008.

CONCLUSION

This article has considered the development of taxes in the People's Republic of China. It has demonstrated how taxation has been used as a tool for social and economic change during the different stages of the history of the People's Republic of China. The emphasis on foreign investment since the Open Door Policy has led to significant developments in the taxation regime. The most recent development considered in this article is the implementation of a new income tax regime for enterprises, domestic and foreign alike. A demonstration of compliance with World Trade Organisation principles, this new income tax regime is ultimately a corporate tax regime that is only now catching up with the unified individual tax regime implemented over a decade ago. However, it represents a recognition that China is at a stage in its economic development that can withstand a reform that brings both domestic businesses and foreign-funded businesses under a uniform regime that aims to provide a level playing field for all. Domestic businesses were at a disadvantage before this unification and that disadvantage led to behaviour that sought to circumvent the disadvantage by utilising the loopholes available between the Domestic and Foreign Enterprise tax rules. This reform is as much an attempt at ensuring competition is equal between domestic and foreign sectors of the Chinese economy as it is about dealing with tax avoidance. The introduction of specific and general anti-avoidance measures is evidence of this dual purpose. It is perhaps too early to judge the performance of this new regime, but once the grandfathering arrangements come to an end, the true impact of the unified *Enterprise Income Tax Law* will become apparent.

NOTES

[1] Accession of the People's Republic of China, Decision of 10 November 2001, WT/L/432.
[2] Finance Minister, Jin Renqing, Explanation on the Draft *Enterprise Income Tax Law* of the People's Republic of China, delivered at the Fifth Session of the Tenth National People's Congress on 8 March 2007 <http://www.npc.gov.cn/englishnpc/Speeches/2007-03/08/content_360344.htm> at 22 May 2011.
[3] Daniel HK Ho, *Tax Law in Modern China: Evolution, Framework and Administration* (2001) 31 *Hong Kong Law Journal* 141, 147.
[4] Ibid.
[5] Jinyan Li, *China's Tax System: An Evaluation* (Spring 1989) 17 *Denver Journal of International Law & Policy* 527, 529.
[6] Ho, above n 3, 145–6. See also Li, above n 5, 529.
[7] Li, above n 5, 530.
[8] Ho, above n 3, 148–9.
[9] Ibid.
[10] Ho, above n 3, 149.
[11] Ibid.
[12] Ho, above n 3, 150.
[13] Ibid.
[14] Li, above n 5, 530.
[15] Kui Hua Wang, *Chinese Commercial Law* (Oxford University Press, 2000, Melbourne) 217.
[16] Li, above n 5, 531.
[17] Ibid.
[18] Ibid.
[19] Ibid.
[20] Ibid.
[21] Ho, above n 3, 151.
[22] Ibid 152.
[23] Li Qun, 'Tax Incentive Policies for Foreign-Invested Enterprises in China' (2008) 18(1) *Revenue Law Journal* 2–3.
[24] Ibid 3.
[25] Li Jin and Richard Krever, 'Globalisation and Modernisation as Drivers for Tax Reform in the Socialist Market Economy' (July 2010) 11 *Theoretical Inquiries Law* 687, 694.
[26] Ibid.
[27] National Bureau of Statistics of China, *China Statistical Yearbook* (2007) Table 18–14 <http://www.stats.gov.cn/tjsj/ndsj/2007/html/R1814e.htm>. It can be seen that during the 1980s, foreign direct investment annually was in the single digit billions of US dollars while in the 1990s the value of that investment annually was in ever-increasing double digit billions of US dollars.
[28] Passed by the 4th Session of the 7th National People's Congress on 9 April 1991.
[29] Jianfu Chen and Suiwa Ke (eds), *Structure of China's Tax System* (CCH Asia Pte Ltd, 2007) ¶50-207.
[30] Li & Krever, above n 25, 701.
[31] Ho, above n 3, 154.
[32] The US-China Business Council, 7. Ministry of Finance (MOF) at <http://www.uschina.org/public/china/govstructure/govstructure_part5/9.html>, Mandate of the Ministry of Finance <http://www.mof.gov.cn/english/english.htm>, no longer available.
[33] See the China Factfile, *State Administration of Taxation* (2006) <http://www.gov.cn/english/2005-10/09/content_75307.htm>.
[34] Ho, above n 3, 156.
[35] China Factfile, above n 33.
[36] China Factfile, above n 33; Ho, above n 3; CCH Asia Pte Ltd, *China Tax and Customs Law Guide Commentary — Tax Policy and Administration*, ¶3-000.
[37] China Factfile, above n 33.
[38] China Factfile, above n 33.
[39] Li & Krever, above n 25, 695.
[40] China's 11th Five Year Plan, delivered at the Fourth Session of the Tenth National People's Congress (NPC); Yang Lei (ed), *Facts and Figures: China's Drive to Build New Socialist Countryside* (2006) <http://www.gov.cn/english/2006-03/05/content_218725.htm>. This document notes that the Agricultural Tax has been collected in China for 2600 years.

[41] *Individual Income Tax Law of the People's Republic of China 1993*, Art 1.
[42] *Implementing Regulations for the Individual Income Tax Law of the People's Republic of China 1994*, Art 6. For further exemptions, see Art 7.
[43] *Value Added Tax Implementing Rules of the People's Republic of China*, Art 1.
[44] *Value Added Tax Provisional Rules of the People's Republic of China*, Art 2.
[45] *Provisional Rules for the People's Republic of China on Business Tax*, Art 1.
[46] *Asia Pacific Guide to Tax and Investment* (PricewaterhouseCoopers, 1998) 37.
[47] Ibid.
[48] *Provisional Rules for the People's Republic of China on Consumption Tax*, Art 1.
[49] *Provisional Rules for the People's Republic of China on Consumption Tax* and *Circular 33*.
[50] Li & Krever, above n 25, 706–7.
[51] Ibid.
[52] Ibid 712–3.
[53] Jin, above n 2.
[54] Ibid.
[55] Ibid.
[56] Ibid.
[57] Ibid.
[58] Ibid.
[59] Ibid.
[60] This was not the case under the *Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises 1991*, nor the *Provisional Regulations of the People's Republic of China on Enterprise Income Tax 1993*. Rather the practice of excluding such non-corporate enterprises was through administrative processes.
[61] CCH Asia Pte Ltd, *China Tax and Customs Law Guide Commentary — Foreign Enterprise Income Tax*, ¶20-101.
[62] Significantly/evidently lower tax rate is defined in Art 118 of the Implementing Regulations to be less than 12.5 per cent.
[63] Where control is defined in Article 117 of the Implementing Regulations as including:
'(1) where a resident enterprise or a Chinese resident directly or indirectly holds 10 per cent or more of voting shares solely in a foreign enterprise, and jointly holds 50 per cent or more of the shares in the foreign enterprise; and
(2) where the shareholding percentage of a resident enterprise or a resident enterprise and a Chinese resident has yet to attain the standard stipulated in item (1) but it/they has/have substantive control over the foreign enterprise in terms of shares, funds, operation and procurement and sale etc.'
[64] CCH Asia Pte Ltd, above n 61.
[65] Nolan Cormac Sharkey, 'China's New Enterprise Income Tax Law: Continuity and Change' (2007) 30(3) *University of New South Wales Law Journal* 833, a 39.
[66] Subject to any rules otherwise prescribed by the State Council, *Enterprise Income Tax Law*, Art 52.

AUTHOR BIO

NATALIE STOIANOFF is a Professor in the Faculty of Law at the University of Technology, Sydney, and the Director of the Master of Industrial Property Program. She is the Chair of the Faculty Research Network for Intellectual Property, Media and Communications, and the Convenor of the China Law Research Group.

Natalie's interdisciplinary research is concerned with the legal, ethical and commercial aspects of biotechnology. In particular, her research interests range from the Patenting of Living Organisms, Technology Transfer and Environmental Taxation. As a joint recipient of an Australian Research Council Discovery Grant, Natalie is currently investigating Intellectual Property enforcement and awareness building in the People's Republic of China.

She is a co-author of the Federation Press publication, Intellectual Property Law: Text and Essential Cases, adopted by several Australian universities and now in its third edition. She has been the author of numerous Patent Law Bulletins, for the publication, Lahore's Patents, Trade Marks & Related Rights Reporter, published by Butterworths, and has edited the multidisciplinary book, Accessing Biological Resources, Complying with the Convention on Biological Diversity, published in 2004 by Kluwer's International Environmental Law & Policy Series.

Natalie has been the recipient of a number of research fellowships including at the Max-Planck-Institute for Intellectual Property, Competition and Taxation Law, Munich, and the Inaugural Professor Anastasios Dontas Travelling Fellowship for her paper on the regulation of genetic technologies in medicine at the Greek/Australian International Legal & Medical Conference, June 2001, Corfu. She is a Visiting Professor at the Faculty of Law, University of Wollongong, and is a regular participant in the annual Global Environmental Taxation conference series publishing on the impact of taxation concessions for mine site rehabilitation, conservation covenants and other environmental activities.