TAXATION

This guide introduces the major taxes applicable to foreign investors doing business in China and outlines recent legislative developments.

Income taxes

Enterprise income tax

Historically, one income tax system applied to domestic enterprises ("DEs") and another applied to foreign enterprises ("FEs") and foreign-invested enterprises ("FIEs"). FIEs include Sino-foreign equity joint ventures, cooperative joint ventures, and wholly foreign-owned enterprises. The statutory income tax rate was 33% (comprising a 30% national rate and a 3% local rate) and applied to DEs and some FIEs. Many FIEs enjoyed 15% or 24% preferential tax rates, as well as tax holidays.

Introduced with the goal of creating a level playing field, the Enterprise Income Tax Law ("EIT Law") was promulgated on May 16, 2007 and took effect on January 1, 2008. The EIT Law provides unified income tax treatment for both DEs and FIEs. On December 11, 2007, the PRC State Council released the Enterprise Income Tax Implementing Rules ("Implementing Rules"), which also took effect on January 1, 2008. Pursuant to the EIT Law and the Implementing Rules, a resident enterprise (including an FIE) is subject to tax on its worldwide income. Foreign tax credits are allowed for income taxes paid to other countries by the resident enterprise, limited to the PRC income tax payable on the same income. Non-resident enterprises and other economic organizations which have establishments in China, or which derive certain income from China, are subject to tax only on their income from PRC sources. Group consolidation is not allowed in the PRC.

For many foreign investors, the EIT Law results in a higher tax burden with the elimination of most preferential tax rates and holidays and a harmonized tax rate of 25%. However, the EIT Law provides for a transition period of five years for FIEs that enjoyed certain preferential rates or tax holidays under the old system. The tax rate for these existing FIEs will increase gradually from the pre-2008 concessionary rate to the new rate of 25% by 2012. Although the EIT Law repealed most tax incentives for FIEs, it provides tax incentives for both FIEs and DEs that invest in high technology, venture capital, and certain other encouraged industries.

Withholding tax is imposed on dividends, interest, royalties, rental income, gain from the transfer of property and other PRC-sourced income, which is derived either:

- by a non-resident enterprise without an establishment in China, or
- by a non-resident enterprise with an establishment in China, when the income is not effectively connected with that establishment.

Dividends were exempted from withholding tax under the old system but are now subject to withholding tax under the EIT Law. The statutory withholding tax rate on all forms of passive income paid to non-resident enterprises is 20% but the Implementing Rules reduce the rate to 10%. The statutory withholding tax rate is also subject to reduction by a tax treaty when applicable. However, with the exception of a handful of tax treaties that address certain types of royalties and capital gains, the vast majority of China's tax treaties generally do not improve the withholding tax treatment that is already available under the domestic law.

Individual income tax

In accordance with the Individual Income Tax ("IIT") Law, IIT is imposed on all individuals, including both Chinese and foreign nationals, residing in or deriving income from China. PRC residents are generally subject to tax on their worldwide income while non-residents are taxed on their PRC-source income only. IIT is imposed on income from wages and salaries at progressive rates from 3% to 45%; on capital gains at a flat 20% rate; and on interest, dividends and royalties at a flat 20% rate. China instituted annual income tax returns from 2006 for individuals earning over RMB120,000 per year (roughly US$15,000).

Turnover taxes

Business tax

All enterprises and individuals that provide taxable services or transfer immovable or intangible property in China are subject to business tax ("BT"). The amount of BT applicable to services is determined by applying the relevant tax rate, which ranges from 3% to 20% depending on the type of service, to the gross amount of the service fees. The BT rate for transfers of immovable or intangible property is 5%, also levied on the gross proceeds. No input tax is available. BT paid is a deductible expense for resident enterprises for enterprise income tax purposes.

On January 1, 2009, the amended Business Tax Regulations and Implementing Rules took effect. Under the new rules, the phrase "provision of labor services within the territory of China" is interpreted to mean that either the service provider or the service recipient is located in China. This means that a non-resident enterprise performing services exclusively outside of China is subject to BT as long as the service recipient is located in China. A circular later issued by the State Administration of Taxation excludes certain services performed by non-resident enterprise to PRC recipients who are present in the overseas jurisdiction.

Value-added tax

The sale of goods, repair and replacement services and the provision of labor services in relation to the processing of goods within the PRC are subject to value-added tax ("VAT"). VAT is also levied on the import of goods into China unless the imports are specifically exempted under special rules. In general, exports are exempted from VAT, and the related input VAT may be wholly or partially refunded. The non-refundable portion is absorbed as a cost of export.

Starting from January 1, 2009, when the amended VAT Regulations and Implementing Rules took effect, the VAT paid for the purchase of fixed assets can be offset against the output VAT of taxpayers with general VAT payer status.

Turnover Tax Reform

China is now undergoing a reform of its turnover tax system to unify VAT and business tax. A pilot reform program began in Shanghai on January 1, 2012 under which VAT has replaced business tax with respect to certain services and the transfer of certain intangibles. The pilot program gradually expanded to other cities and provinces during 2012 and rolled out nationally on August 1, 2013. The pilot program will gradually expand to other business sectors, and VAT is expected to completely replace business tax by the end of 2015.

Service providers are no longer subject to business tax if they are engaged in the industries covered by the pilot program; instead, they pay VAT at different rates as applicable.

The four types of industries covered by the pilot program are the “transportation service industry”, the “postal service industry”, the “telecommunications service industry” and “certain modern service industries”, which include R&D and technical services, information technology services, cultural and creative services, logistical support services, leasing of tangible movable property services, certification services and consulting services, and radio, film and television services. As of November 2014, the two largest sectors yet to become subject to VAT are financial services and real estate services and transactions.

Transitional rules are also available to mitigate the negative impact on the tax burden of service providers that enjoyed preferential treatments under the business tax regime.

Stamp duty

Stamp duty is levied on the execution or receipt in China of certain documents, including contracts for the sale of goods, the undertaking of processing work, the contracting of construction and engineering projects, leases, loans, and agency and other non-trade contracts. Stamp duty is also levied on documentation effecting the transfer of property/shares, on business account books and on certificates evidencing rights and licenses. The rates of stamp duty vary. For the transfer of shares in a PRC enterprise, the applicable stamp duty rate is 0.05% of the contract value for each party.

Consumption tax

Consumption tax is levied on the importation, production and processing of 11 categories of consumable goods, including tobacco, alcoholic drinks, cosmetics, skin- and hair-care products, jewelry, fireworks, gasoline, diesel oil, tires, motorcycles, and automobiles.

Other taxes

Customs duties are imposed on exports and imports of goods. Most export items are duty free, and the duty to be paid on exports that are not exempt is based on the FOB value. Imports are generally assessed on their CIF (cost, insurance and freight) value, with all included charges verified by the customs administration. When applicable, the rate of duty ranges from 0% to 270%, depending on the nature and the country of origin of the goods concerned. Customs duties paid are deductible expenses for enterprise income tax purposes.

Land appreciation tax ("LAT") is levied on gains realized from real property transactions at progressive rates from 30% to 60%, based on the land value appreciation amount, which is the excess of the consideration received from the transfer or disposition of real property over the total deductible amount.

Deed tax is levied on the purchase or sale, gift or exchange of ownership of real property. The transferee/assignee is the taxpayer. Generally, the rates range from 3% to 5%.

Other taxes include real estate taxes, vehicle and vessel taxes and resource tax.

Transfer pricing rules

The EIT Law includes rules on transfer pricing. Under these rules, all business transactions between related parties must be settled according to an "arm's length" standard. If the parties fail to meet this requirement, the tax bureau may make special adjustments.

Tax treaties

China has signed bilateral tax treaties with about 101 jurisdictions. The treaties are primarily to avoid double taxation and to prevent tax evasion. The tax treaties generally follow the model treaty of the OECD and the model United Nations treaty.