China Tax Update

Beijing/Hong Kong/Shanghai

2018 June/July issue

China Tax Update is a publication of Baker & McKenzie's China Tax Group.

For further information, please contact:

Beijing

Jinghua Liu (Tax and Dispute Resolution)
+86 10 6535 3816
jinghua.liu@bakermckenziefenxun.com

Abe Zhao (Tax and Transfer Pricing)
+86 10 6505 3862
abe.zhao@bakermckenziefenxun.com

Jason Wen (Tax)
+86 10 6535 3974
jason.wen@bakermckenzie.com

Shanghai

Brendan Kelly (Tax)
+86 21 6105 5950
brendan.kelly@bakermckenzie.com

Nancy Lai (Tax)
+86 21 6105 5949
nancy.lai@bakermckenzie.com

Hong Kong

Amy Ling (Tax)
+852 2846 2190
amy.ling@bakermckenzie.com

San Francisco

Jon Eichelberger (Tax)
+1 415 984 3857
jon.eichelberger@bakermckenzie.com

New York

Shanwu Yuan (Tax and Transfer Pricing)
+1 212 626 4212
shanwu.yuan@bakermckenzie.com

In this issue of the China Tax Update, we will discuss the following tax developments in China:

1. China completes the tax administration reform to merge state and local tax bureaus

On 20 July 2018, China announced the merger of the county/district-level state and local tax bureaus across the country. This announcement signals the final stages of China's tax administration reform to merge the state tax bureaus with the corresponding local tax bureaus into a consolidated local tax authority.

Introduction

Since 1994, state and local tax bureaus have existed in parallel at the provincial, municipal and county/district levels in places other than Shanghai and Tibet. State tax bureaus were responsible for collecting taxes for the central government such as the consumption tax, as well as certain taxes shared between the central and local governments such as enterprise income tax (EIT) and value-added tax (VAT). Local tax bureaus were responsible for the collection of local taxes such as deed tax and land appreciation tax, as well as some other taxes shared between the central and local governments such as individual income tax (IIT).

In March 2018, China started a reform to merge corresponding state and local tax bureaus into a consolidated local tax authority. China announced the provincial-level merger on 15 June 2018, the municipal-level merger on 5 July 2018 and the county/district-level merger on 20 July 2018.

After the merger, the new local tax authority will assume all functions previously performed by the corresponding state and local tax bureaus. The local tax authority will follow both the Sate Administration of Taxation (SAT) and local government directives, with the SAT playing the leading role. Necessary internal arrangements such as personnel adjustments will be made to enable the local tax authority to function properly. And new procedural guidance will be issued so that taxpayers can fulfill tax formalities with the new local tax authority.

Implications for taxpayers

The tax agency reform could have both positive and negative implications for taxpayers.

First, the reform will reduce the compliance burden for taxpayers. Prior to the reform, a taxpayer would need to deal with two in-charge tax bureaus, state and local, even for a single tax issue or for closely related tax issues, such as information update regarding change of shareholder, tax deregistrations, etc. After the merger, the taxpayer will only have one in-charge tax authority and will no longer need to duplicate its tax formalities with two tax bureaus.

Second, taxpayers could face increased tax audit risks by being supervised by a single tax bureau. In having been supervised by two tax bureaus, taxpayers benefitted with reduced tax audit risks because those two tax bureaus did not always effectively share information or coordinate action. For example, permanent establishment (PE) assessment is a typical area where information sharing was lacking. Frequently, state tax bureaus would initiate PE assessments to collect EIT from non-residents who had employees providing services in China, while the corresponding local tax bureau would not initiate an audit to collect IIT from the employees, or vice versa. With the merger, tax information should be shared more frequently between different tax divisions within the same tax authority. If the EIT division initiates a PE assessment to collect EIT, the IIT division is likely to receive this information and then use the PE assessment as a basis to collect IIT.

Finally, taxpayers could expect more sophisticated technical discussions with the local tax authorities. With the merger, the SAT will play a lead role in directing the local tax authorities. The SAT has already established three Special Commissioners' Offices (SCO) in Beijing, Chongqing and Guangzhou for this purpose. Each SCO will be responsible for supervising local implementation of SAT tax policies.[1] Generally speaking, the SAT shows more respect to tax law and regulations as compared to the local tax authorities. Taxpayers may expect the local tax authorities to be more open to discuss technical isssues due to the SAT’s greater influence on the local tax authorities.

Recommendation

In response to the greater information sharing within the tax authority after the reform, taxpayers must fully assess their tax risks for all tax arrangements, and get well prepared to address potential tax audit risks (if any) before the tax authority comes to knock on the door.

Given the greater SAT influence on the local tax authorities, taxpayers may consider leveraging SAT impact to develop more sophisticated technical discussion in the case of disputes with the local tax authorities. Taxpayers should be more confident to challenge tax authority decisions to achieve better tax settlement when a sound legal basis exists and it is commercially necessary and feasible to do so.

---

[1] The Beijing SCO supervises local tax authorities in Beijing, Tianjin, Hebei, Shanxi and Inter Mongolia; the Guangzhou SCO supervises local tax authorities in Hubei, Hunan, Guangdong (including Shenzhen) and Hainan; and the Chongqing SCO supervises local tax authorities in Chongqing, Sichuan, Guizhou, Yunnan, Tibet and Guangxi.

2. New SAT bulletin provides document requirements for EIT deduction

On 6 June 2018, the SAT issued its long-awaited Bulletin 28[2] to provide unified guidance to tax bureaus across the country on what supporting documents are needed to substantiate EIT deductions. Bulletin 28 applies to both resident and non-resident enterprises with effect from 1 July 2018.

Documents required

Bulletin 28 classifies the EIT deduction supporting documents into two broad categories: (i) original accounting vouchers prepared by the enterprise itself to book expenditure items; and (ii) vouchers obtained from an external party, such as statutory invoices, tax payment certificates and payment receipts.

Both internal and external vouchers must comply with relevant rules. Specifically, Bulletin 28 provides that non-compliant external vouchers such as fake VAT invoices cannot be used to support EIT deductions. If an enterprise receives non-compliant external vouchers, the enterprise generally should ask the counterparty to reissue compliant vouchers. Even if the enterprise cannot obtain compliant replacement vouchers, it might still be allowed to take the EIT deduction in exceptional cases if the enterprise can provide other documentary evidence in lieu of the vouchers to authenticate the relevant expense. Substitute documentation in lieu of compliant vouchers is only permitted in exceptional cases such as when the counterparty that issued the non-compliant external vouchers has been deregistered or has been determined to be an abnormal taxpayer by the tax authority and thus cannot reissue the external vouchers.

According to Bulletin 28, different document requirements apply to onshore and offshore expenses. Further differences may arise for onshore expenses, depending on whether the relevant expenses are incurred for VATable items and whether the counterparty involved is an entity or individual. The following table summarizes the documents required for each expense item:

Expense Item	Counterparty	Supporting Documents
Onshore Expense – incurred for VATable item	Registered VAT taxpayer (including an individual above VAT threshold[3])	VAT invoice
	Non-tax registered entity or individual below VAT threshold	VAT invoice; or payment receipt and internal accounting voucher
Onshore Expense – incurred for non-VATable item	Entity	External voucher such as payment receipt
	Individual	Internal accounting voucher
Offshore Expense	Entity or individual	Invoices (or payment receipt with similar nature), relevant tax payment certificates

2 *Administrative Rules Regarding Supporting Documents for Enterprise Income Tax Deduction*, SAT Bulletin [2018] No. 28, dated 6 June 2018, effective from 1 July 2018.

3 The VAT threshold, depending on location, generally equals monthly VATable revenue of CNY 5,000 to 20,000 if the individual pays VAT on a monthly basis, or per transaction or daily VATable revenue of CNY 300 to 500 if the individual pays VAT on per transaction or a daily basis.

Timing

According to Bulletin 28, an enterprise generally must obtain qualified documents to support the EIT deduction of expenses before the relevant EIT annual filing deadline, i.e., 31 May of the next year.

If an enterprise takes EIT deduction on expenses without obtaining the qualified documents before this deadline, the tax bureau may require the enterprise to provide qualified documents within 60 days of notification. If the enterprise fails to provide qualified documents within 60 days, the enterprise will permanently lose its ability to take the EIT deduction.

In contrast, if the enterprise decides not to take the EIT deduction before obtaining the required documents, the enterprise is allowed to carry back the relevant expense to the tax year when the expense incurred provided that the enterprise obtains qualified documents within five years.

Observations

The SAT used to instruct local tax bureaus to disallow EIT deduction if an enterprise did not obtain valid vouchers for an expense. However, before Bulletin 28, no rules specified the document requirements for EIT deduction. Without these rules, local practice varied and might be unpredictable. As such, multinational companies (MNCs) struggled with EIT deduction supporting document issues, especially the availability of EIT deduction in the absence of a valid VAT invoice. With Bulletin 28's document requirements, MNCs have much-needed guidance and certainty in taking EIT deductions.

Meanwhile, it is important to note that Bulletin 28 still requires valid external vouchers to take an EIT deduction for most expenses. MNCs and their Chinese subsidiaries must thoroughly understand the document requirements for EIT deductions under Bulletin 28 and obtain valid documents to avoid losing EIT deduction benefits.

3. TASE tax incentive expands to more industries

On 19 May 2018, five government agencies, including the Ministry of Finance (MOF) and the SAT, jointly issued Notice 44[4] to expand the technology advanced service enterprise (TASE) tax incentive to cover new service sectors nationwide.

As background, qualified TASEs can enjoy a reduced EIT rate of 15% (the standard rate is 25%). This reduced rate previously only applied to business process outsourcing (BPO), information technology outsourcing (ITO) and knowledge process outsourcing (KPO) services.[5]

On 10 November 2016, China initiated a pilot program in 15 designated zones to expand the TASE tax incentive to cover new service sectors, including computer and information services, R&D and technical services,

---

[4] *Notice on Expanding the Enterprise Income Tax Policies for Technology-advanced Service Enterprises in the Service Trade Innovative Development Pilot Zones to the Whole Country,* Cai Shui [2018] No. 44, dated 19 May 2018, retroactively effective from 1 January 2018.

[5] The TASE tax incentive for BPO, ITO and KPO services previously only applied in 31 designated cities, but has expanded nationwide since 1 January 2017.

cultural technical services and traditional Chinese medical services. The pilot program was effective from 1 January 2016 to 31 December 2017. Following the issuance of Notice 44, the TASE tax incentive has expanded to cover these new service sectors nationwide with effect from 1 January 2018.

The TASE qualifying conditions for these new service sectors are the same as those applicable to BPO, ITO and KPO services under Notice 79[6] and are nationally unified. But the administrative rules regarding TASE recognition may vary from province to province.

Observations

The expansion of the TASE tax incentive to cover R&D services is welcome news for MNCs with PRC R&D entities. Every MNC should consider fully assessing its PRC R&D entity's eligibility for TASE qualification and timely apply for TASE recognition with the competent local authority to enjoy the 15% reduced EIT rate. Even if the Chinese entity currently fails to qualify, MNCs can consider necessary arrangements to improve the Chinese entity's ability to satisfy the TASE conditions in future years.

4. Super deduction incentive expands to cover expenses incurred for outsourced offshore R&D activities

On 25 June 2018, the MOF, the SAT, and the Ministry of Science and Technology jointly issued Notice 64[7] to allow resident enterprises to take super deductions on expenses incurred for outsourced offshore R&D activities with effect from 1 January 2018.

"Super deduction" refers to the EIT deduction[8] equal to 150% for enterprises or 175%[9] for small- and medium-sized technology enterprises on qualified R&D expenses actually incurred. Before Notice 64, the super deduction rules distinguished between onshore and offshore contract R&D activities, and only allowed the entrusting party to take the super deduction on R&D expenses incurred by a domestic entrusted party.

Notice 64 now also allows the entrusting party to take the super deduction on offshore contract R&D expenses, provided the entrusted party is an entity instead of an individual. As with domestic contract R&D expenses, only 80% of the actual offshore contract R&D expenses can qualify for the super deduction. In addition, offshore contract R&D expenses that qualify for the super deduction are capped at two-thirds of the total amount of qualified domestic R&D expenses.

---

6 *Notice on Expanding the Enterprise Income Tax Policies for Technology-advanced Service Enterprises Nationwide*, Cai Shui [2017] No. 79, dated 2 November 2017, retroactively effective from 1 January 2017.

7 Notice on Super Deduction Policies Relating to Expenses Incurred for Outsourced Offshore R&D Activities, Cai Shui [2018] No. 64, dated 25 June 2018, retroactively effective from 1 January 2018.

8 Super deduction also refers to amortization if the R&D activities resulted in an intangible asset and the R&D expenses are calculated into the cost of that intangible asset.

9 The 175% super deduction for small- and medium-sized technology enterprises is effective from 1 January 2017 to 31 December 2019. The State Council has announced its intent to increase the super deduction from 150% to 175% for all enterprises. The implementing rules for this increase have yet to be issued by the MOF and the SAT.

Observations

Due to the cap on the super deduction, onshore and offshore contract R&D activities still might not receive equal super deduction treatment. As such, enterprises that need to engage a third party to conduct R&D activities should consider balancing the use of onshore and offshore contract R&D service providers (if commercially feasible) to take full advantage of the super deduction incentive.

5. China renews EIT incentives for integrated circuit manufacturing enterprises

On 28 March 2018, the MOF, the SAT, the National Development and Reform Commission, and the Ministry of Industry and Information jointly issued Notice 27[10] to renew expired EIT incentives and create new EIT incentives for integrated circuit (IC) manufacturing enterprises.

For any IC manufacturing enterprise which are established on or before 31 December 2017 but have not realized any profits by that date, Notice 27 renews the five- or ten-year tax holiday[11] under a 2012 notice[12] that had expired in 2017.

For any IC manufacturing enterprise or projects established or launched after 31 December 2017, Notice 27 now provides the following new tax holidays:

- a five-year tax holiday for IC manufacturing enterprises or projects that have an operation period of at least 10 years and manufacture ICs with a circuitry width of less than 130 nanometres
- a ten-year tax holiday for IC manufacturing enterprises or projects that have an operation period of at least 15 years or a total investment of more than CNY 15 billion and manufacture ICs with a circuitry width of less than 65 nanometres

Compared to the 2012 notice, Notice 27 has higher requirements for the circuitry width and for the investment amount. However, Notice 27 relaxed the R&D expense requirement for an enterprise to qualify as an IC manufacturing enterprise by only requiring the total R&D expense to account for at least 2% (previously 5%) of its total revenue.

Observations

IC manufacturing enterprises will welcome the new tax holidays that can apply on a project basis. This would allow enterprises established before 2018 can claim the project-based tax holiday for IC manufacturing projects launched in or after 2018.

---

[10] *Notice on Enterprise Income Tax Policy of Integrated Circuit Manufacturing Enterprises*, Cai Shui [2018] No. 27, dated 28 March 2018, effective from 1 January 2018.

[11] The five-year tax holiday refers to a two-year tax exemption followed by a three-year 50% tax reduction. The ten-year tax holiday refers to a five-year tax exemption followed by a five-year 50% tax reduction.

[12] *Notice on Enterprise Income Tax Policy to Further Encourage Software Industry and Integrated Circuit Industry*, Cai Shui [2012] No. 27, dated 20 April 2012, retroactively effective from 1 January 2011.

In addition to the renewed tax holidays for IC manufacturing enterprises, we expect new rules later this year to renew the tax holidays under the 2012 notice for qualified IC designing and software enterprises. Those tax holidays also expired on 31 December 2017.

6. China unifies the threshold for small-scale taxpayers

On 4 April 2018, the MOF and the SAT jointly issued Notice 33[13] to unify the small-scale taxpayer threshold in all industries. Notice 33 no longer distinguishes taxpayers based on their different business activities.[14] Notice 33 sets the threshold for all taxpayers to qualify for small-scale taxpayer status. To qualify, their annual revenue from sales subject to VAT may not exceed CNY 5 million.

With Notice 33 taking effect on 1 May 2018, an individual or entity that had been registered as a general taxpayer under the previous rules but that now qualifies as a small-scale taxpayer under Notice 33 can change to small-scale taxpayer before 31 December 2018. After the change, the taxpayer cannot use its input VAT (including input VAT incurred when it was a general taxpayer) to offset its future VAT liability. As such, a taxpayer who intends to change to small-scale taxpayer should consider this offset loss and choose the most tax-efficient time for the change.

7. VAT rates in various sectors reduced by 1%

On 4 April 2018, the MOF and the SAT jointly issued Notice 32,[15] which reduces the VAT rates by 1% for a wide range of sectors with effect from 1 May 2018.

Specifically, the VAT rate has been reduced from 17% to 16% on:

- the sale or import of goods
- the provision of processing, repair and replacement services
- the leasing of tangible movable property

Further, the VAT rate has been reduced from 11% to 10% on:

- the sale or import of agricultural products and certain life necessities
- the provision of transportation, postal, basic telecommunication and construction services
- the leasing or transfer of immovable property

---

[13] *Notice regarding Standardizing Qualifications of Small-scaled Taxpayers*, Cai Shui [2018] No. 33, dated 4 April 2018, effective from 1 May 2018.

[14] Before Notice 33, to qualify as a small-scale taxpayer, the taxpayer's annual sales revenue could not exceed: (i) CNY 500,000 or CNY 800,000 if the taxpayer was engaged in the sale of goods or the provision of processing, repair and replacement services; or (ii) CNY 5 million if the taxpayer was engaged in the provision of other VATable services or the transfer of immovable or intangible property.

[15] *Notice regarding the Adjustment of VAT Rate*, Cai Shui [2018] No. 32, dated 4 April 2018, effective from 1 May 2018.

Correspondingly, the 17% and 11% VAT refund rate for qualified export of goods and services also decreased by 1%. As a transitional arrangement, Notice 32 allows manufacturing enterprises to use the 17% or 11% VAT refund rate for exports before 31 July 2018. Similar transition arrangements also apply to trade enterprises if their exported goods were purchased at the VAT rate of 17% or 11%.

8. China extends deed tax and land appreciation tax exemption for enterprise restructuring

The MOF and the SAT jointly issued Notice 17[16] on 2 March 2018 and Notice 57[17] on 16 May 2018 to extend the deed tax and land appreciation tax emption for qualified enterprise restructuring.

Notice 17 extends the deed tax exemption treatment for real estate transfers involved in a qualified corporate merger, demerger or internal transfer from 1 January 2018 to 31 December 2020. Additionally, Notice 17 adds a new category of internal transfer exempted from deed tax. Under Notice 17, when a parent enterprise makes an equity contribution using land or housing to its wholly owned subsidiary, that land or housing transfer is deemed as an internal transfer and thus exempted from deed tax. Notice 17 will remain valid until 31 December 2020.

Notice 57 extends the land appreciation tax exemption for real estate transfers involved in qualified corporate mergers, demergers and equity contributions. The exemption was set to expire on 31 December 2018, but it has been extended to 31 December 2020.

Observations

Notice 17 and Notice 57 indicate the Chinese government's continued support for enterprise restructuring. Notably, while the equity contribution of land is generally exempt from land appreciation tax, the deed tax emption only applies to the equity contribution of land from a parent company to its wholly owned subsidiary. Taxpayers should pay close attention to the application requirements for these tax exemptions when planning enterprise restructuring to ensure full use of the tax incentives and to avoid unnecessary tax costs.

---

16 *Notice on the Deed Tax Policy to Continue the Support for the Transformation and Restructuring of Enterprises and Public Institutions*, Cai Shui [2018] No. 17, dated 2 March 2018, retroactively effective from 1 January 2018.

17 *Notice of the Ministry of Finance and the State Administration of Taxation to Continue Implementing the Land Appreciation Tax Policy for Enterprise Restructurings*, Cai Shui [2018] No. 57, dated 16 May 2018, retroactively effective from 1 January 2018.

www.bakermckenzie.com

Suite 3401, China World Tower 2
1 Jianguomenwai Dajie
Beijing 100004, China
Tel: +86 10 6535 3800
Fax: +86 10 6505 2309

14th Floor, Hutchison House
10 Harcourt Road, Central
Hong Kong SAR, China
Tel: +852 2846 1888
Fax: +852 2845 0476

Unit 1601, Jin Mao Tower
88 Century Avenue, Pudong
Shanghai 200121, China
Tel: +86 21 6105 8558
Fax: +86 21 5047 0020