
China's Tax Planning and Applicable Law under the New Corporate Income Tax

By Austin X.D. Zhang

A New Era in China's Tax Reform

The Corporate Income Law of the People's Republic of China (the Law) adopted on 16th March 2007 will be effective as of 1st January, 2008. The Law is a basic rule-setting move that will create a playing field for all enterprises, a cornerstone principle of market economics¹. The significance of the Law with the provisions on controlled foreign companies (CFC)² and place of effective management or the actual administration locus³ will improve China's anti-tax dodge in relation to offshore tax havens. The provisions would make the Chinese companies and individuals and foreign investment who are operating cross-boarder investment, trade and services with the structure of offshore tax planning the target under CFC and actual administrative locus provisions. Chinese companies (both domestic and foreign investment in China) using offshore companies will not easily change the structures at the date of effectiveness of the Law, but they either trust to luck or look for ways of changing slowly. The Law does not impact the first position in inbound international investment in China because of the huge market. Nevertheless it raises questions on how to make well planned tax and legitimate structures with preciseness and due care by professionals who are familiar with Chinese laws.

¹Xin Zhiming, China Daily 03/20/2007

²Article 45 When the enterprises established and controlled by the resident enterprises or the resident enterprises together with the Chinese resident citizens, and located in those countries or regions where the actual tax level is lower significantly than the tax rate regulated by the Article 4, paragraph 3 in this law, do not distribute, or less distribute. The profit not according to the proper operation, those part of the profit belonged to the resident enterprises should be added to the enterprise's term income**.

³ Article 50 The resident enterprise's tax locus complies with the registering locus unless otherwise stated in the tax law or administrative regulations, but the tax locus is the actual administration locus in PRC if the registering locus is abroad. Resident enterprise pays income tax on a consolidated basis if it establishes a non-legal person operation institute in PRC.

Official Attitude towards Tax Havens

Let us have a look of the case of Gome and Suning, China's largest and the second largest home-appliance retail chains. Gome became a foreign company after its Hong Kong IPO in 2004⁴ and enjoyed tax rates of 9%, 10.6% and 11.2% respectively from 2004 to 2006. It paid corporate income tax of about 20% in 2003. In contrast, subsidiaries of Suning Appliance, China's second biggest mainland electronic chain retailer and Gome's major rival, have to pay 33% in other cities out of Shenzhen Special Economic Zones.

The great advantage of being a foreign company is attracting hundreds of thousands of Chinese companies and individuals to register companies in offshore jurisdictions because of zero tax and territory tax regime. According to the National Bureau of Statistics of PRC, Foreign Direct Investment (FDI) used in China topped 63 billion \$US in 2006, meanwhile the PRC Ministry of Commerce's information shows that the top 10 countries and regions invested in China in January 2007 was Hong Kong, with 1.677 billion US\$, following it is the British Virgin Islands, with 1.019 billion US\$ of investments. Other regions in the top list are South Korea, Japan, Singapore, U.S., Mauritius, Taiwan, Cayman Islands, and Samoa. These ten countries and regions accounted for 86.62% of China's total actual foreign investment, and 6 among the top 10 are low tax jurisdictions or tax havens. Officials of State Administration of Tax (SAT) say that foreign companies claim losses in China; two-thirds of them have "extraordinary losses". Some domestic enterprises would try every possible ways to become "foreign companies" so as to enjoy tax breaks. Once registered in offshore tax havens, the Chinese companies can return to China in the form of foreign direct investment, qualifying themselves for favorable taxation rates and tax incentives, paying income tax at rates as low as 10%. According to officials at the anti-tax-evasion division of SAT, transfer pricing is the most common way of evading taxes, accounting for 60% of all types of tax evasion. Foreign companies inflate the cost of production equipment, raw materials and labor, and export products at falsified low prices, transferring most of the profits - and tax liabilities - to their sister companies in other countries to capitalize on lower tax rates there. Such business activities by foreign companies not only enable their enterprises in China to appear unprofitable, but also trigger an increasing number of anti-dumping charges, launched by the US and Europe, against Chinese products. The accounting expert said transfer pricing has become a common practice for multinational companies under economic globalization. Mei Xinyu, a Chinese researcher said among China's utilized FDI of \$72.4 billion in 2005, one-third was Chinese investment overseas that came back disguised as foreign capital to take advantage of the tax breaks. Mainland China is becoming rapidly a market for

⁴ Hong Kong is the Special Administrative Region of PRC and it is treated as a foreign economy. -notes from the author

offshore company formation that are being popularly used in China by domestic companies and foreign investors as well as Chinese individual investors. In order to contain and furthermore block the tax avoidance, the Law defines that resident enterprises be the ones which registered within the territory of the PRC, or registered in accordance with the laws of foreign nations or regions with a place of effective management in the territory of the PRC, and the non-resident enterprises be the ones which registered in accordance with the laws of foreign nations or regions with a place of effective management or have establishment or places in PRC, and which though without establishments or places in PRC have income sourced from PRC.

Anti Tax Dodge

The CFC and place of administration provisions impact the use of offshore companies due to the fact that the countries or regions where the actual tax level is lower significantly than the tax rate regulated by the Article 4⁵. These countries and regions are tax havens defined by OECD. The Law does not specify the names of tax havens or the meaning of “controlled”, but the State Council will soon promulgate the detailed rules of implementation. In viewing above, in my opinion the SAT takes time and needs experiences to improve the supervision system and expertise in administration. International tax planning is increasingly demanded by Chinese companies and individuals at the circumstances of internationalization or “going abroad” which is strongly encouraged by Chinese government. Utilization of tax havens benefits Chinese enterprises in international market only if we do not intervene Chinese domestic market as long as China has huge foreign currency reserve and urgently needs capital investment to other countries or regions where it will have better feedback or it may have strategic concerns.

The Applicable Law and Execution

⁵ Article 4 The Enterprise Income Tax is levied at the rate of 25 percent. Non-resident enterprises shall pay tax computed at 20 percent of its earned income mentioned in Article 3 , paragraph 3.

The Law identifies resident companies and non-resident companies in Article 2⁶ on base of registration, source of income, place of management and control by Chinese resident companies or residents. The applicable law is specified herein the Law which governs residents or non-residents companies. In practice, the Law may govern exclusively the companies with locus in China as the tax authorities may take evidence and conduct investigation or the Chinese court may take preserve measures; nevertheless, assets of the companies outside China is under a foreign law governing, and the Law is not applicable therefore. The bilateral tax treaty or multilateral convention is the channel to obtain tax payers' information. Tax avoidance is not usually an unlawful practice in many countries so that judicial body is unable to be involved in. But if it is tax evasion defined by China' Criminal law Article 201⁷ and Article 203⁸, it would be possible for judicial body to intervene. The execution of assets of a foreign company with locus outside China is hardly possible as identification of the company's assets is difficult with offshore structure and protection of banking secrecy. The Chinese authorities might find the solution through diplomatic channels. The most important point here is that an offshore company is governed by the laws of the jurisdiction where it is registered and the company's assets be located in a jurisdiction no matter they are immovable or movables governed by the laws of the place where assets are located. Theoretically CFC is for both resident and non-resident companies. In practice non-resident companies do not have executed assets in China, and the non-resident provision in the Law is with no realistic effectiveness although the applicable law is the Chinese law that governs acts of the non-resident companies. But this does not deny the big step of Chinese corporate income tax law in its developing economy. I think the supervision, administration and an expertise team are criteria when the detailed rules of implement are made by the State Council.

Enlightments

1. Tax havens identified by OECD will be the main target in the Law for anti tax dodge purposes as long as the tax authorities are well aware of the situation in that FDI multi-national companies are using vehicles of tax havens that have helped dodged much taxation. Offshore tax havens would be indicated in rules of detailed

⁶Article 2 The Enterprise contains resident enterprises and non- enterprises.

The resident enterprises in this Law shall be the enterprises which registered within the territory of the People's Republic of China, or registered in accordance with the laws of foreign nations/regions but had place of effective management in the territory of the PRC.

The non-resident enterprises in this Law shall be the enterprises which registered in accordance with the laws of foreign nations/regions had no place of effective management in the territory of the PRC, have establishments or places in PRC, and which, though without establishments or places in PRC, have income from sources within PRC.

⁷ Article 201 refers to liabilities of not filing or forging or destroying of tax reports, accounting statements, book keepings, records and penalties---noted by the author.

⁸ Article 203 refers to liabilities of transferring or concealing of taxable assets and penalties---noted by the author

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- implement by the State Council of PRC under Article 4 and Article 45 because their tax is lower than 25% that is set in the Law. The Chinese government is actively talking to tax havens on bilateral agreement on exchanging of information and crack down tax evasion. It will not have an obvious result in short run but cooperation on anti-money laundering or anti-corruption might approach a quick agreement.
2. Offshore companies that keep account with banks in China will have to reconsider their arrangement if they are using their suppliers' addresses for liaison or delivery of orders. Many non-state-owned Chinese companies and individuals have made so called tax structure through consulting companies who have no knowledge on Chinese tax laws, having been using their domestic administration in China when they register companies in various countries including tax havens in terms of receiving payment from outside China with offshore bank account opened with banks in China. It is obviously under CFC provision of Article 45.
 3. Members or directors or officers of offshore companies with management or administration in China may be liable by offending Chinese criminal law Article 201 and Article 203 on tax.

Conclusion.

No one will like to lose the opportunity in making money in the fast growing and huge Chinese market. But precise and well made tax plan is the key factor of a successful and lawful business. In my opinions, companies registered in countries or regions who have signed tax treaties with China will be one of the best solutions in tax planning in China. Hong Kong will also be one of the best solutions concerning the tax treaty signed with its motherland. The demand of tax planning in China will be increasing sharply when the Law is implemented and tax planning as a business has enormous potentialities. Choice of applicable laws with due care by Chinese expertise is the priority in China's tax planning. In light of this, the precise tax planning is the best way to avoid troubles.

*Notes: The translation of the abstract of Corporate Tax Law of PRC is only for reference.

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