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China's tax authorities focus on development of anti-avoidance

China tax authorities are determined to develop its anti-avoidance administration quickly in terms of both skills and numbers. In 2009, the total tax revenue recovered under anti-avoidance enforcement hit a record high of RMB 2 billion, representing a 69% growth from 2008. In order to clarify and standardize the work procedures for anti-avoidance enforcement and the responsibility of different levels of local tax authorities, the SAT plans to issue further guidelines later this year as a follow-up to the "Special Tax Adjustment Implementation Measures (Trial)" issued in 2009. In this new environment it is critical for all companies to not only operate in accordance with the technical requirements of the tax law but with its spirit – the SAT has repeatedly shown that it intends to examine substance over form in the coming years.

Value Added Tax General Taxpayers – Recent Developments

Over the past few months the State Administration of Taxation ("SAT") has issued a number of regulations and policies regarding the treatment of "general" taxpayers in accordance with China's value added tax regime. We now explore these clarifications and examine how they impact upon the application of VAT.

General and Small-Scale Taxpayers

Under China's VAT system a distinction is made between "general" and "small-scale" taxpayers. Small-scale taxpayers are subject to a simplified tax basis and a lower rate of tax of 3% in contrast to the usual rate which can be as high as 17%. However, small-scale tax taxpayers are not entitled to a credit for VAT previously paid in the supply chain. A small-scale taxpayer is defined in Article 28 of the *Detailed Rules for the Implementation of the Interim Regulation of Value Added Tax* as:

- (1) a taxpayer engaged in goods production or provision of taxable services or a taxpayer mainly engaged in goods production or provision of taxable services and concurrently engaged in wholesale or retail of goods, whose annual sales amount subject to value-added tax is not more than 500,000 yuan; and
- (2) a taxpayer other than one as prescribed in the preceding subparagraph (1), whose annual taxable sales amount is not more than 800,000 yuan.

The phrase "mainly engaged in goods production or provision of taxable services" as mentioned in paragraph 1 hereof means that the annual sales amount of the goods production or provision of taxable services of a taxpayer accounts for more than 50% of its annual taxable sales amount.

Article 13 of the *Interim Regulations of Value Added Tax* also provided that '[w]here a small-scale taxpayer with sound accounting is able to provide accurate tax-related materials, it may apply to the competent taxation organ for determination of its qualification for not being treated as a small-scale taxpayer

(cont p. 2)



VAT CLARIFICATION FOR GENERAL TAXPAYERS

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On 10 February 2010 the SAT issued *Administrative Measures for the Recognition of General Value Added Taxpayers* (Order of the SAT No. 22) ("Recognition Measures") which provide more detail on requirements for obtaining general taxpayer status. Importantly, Article 3 provides that all taxpayers, subject to certain exceptions, that exceed the small-scale taxpayer threshold, must apply for general taxpayer status. One of these exceptions is for enterprise with infrequent VAT taxable activities. Article 4 further provides that a taxpayer with a "fixed place of business" may make an application for general taxpayer status despite not exceeding the required threshold of annual sales.

On 7 April 2010, the SAT issued two further notices in relation to applications for general VAT taxpayer status; *Notice Clarifying Articles of the Recognition Measures* (Guoshuihan [2010] No. 139) ("Notice 139") and *Notice on the Issuance of the Administrative Measures on General Taxpayers in Supervisory Period* (Guoshuifa [2010] No. 40) ("Notice 40"). Importantly, where taxpayers are required to make an application for general taxpayer status in accordance with the Recognition Measures, Notice 139 requires that such an application be made within 10 days after receiving the tax notice from the local tax authorities. Those who fail to submit applications on time will not enjoy tax exemptions and cannot use VAT invoices.

The Recognition Measures and Notice 139 also shift the time period for determining an enterprise's sales from a calendar 12 months to any 12 month period of operation of the enterprise (Notice 139 makes it clear that this period of operation includes the period in which no turnover is generated). Under Article 8 of the Recognition Measures and Notice 139, an enterprise must, within 40 days after the filing period in which they exceed the small-scale taxpayer threshold, submit an application for general taxpayer status. Where a taxpayer fails to make such an application within the prescribed time limit, the tax authorities are required to issue Notice of Tax-related Matters to the taxpayer. As noted above, a taxpayer must respond to such a notice within 10 days or be prevented from using input tax credits and special VAT invoices for determining their VAT tax liability.

CHINA ANNOUNCES RESOURCES TAX PILOT PROGRAM FOR XINJIANG PROVINCE

In late July the Chinese president, Hu Jintao, announced a series of tax reforms to in Xinjiang province. This comes after a period of unrest in the province following violent protests in 2009. The reforms include the imposition of a resources tax for oil, gas and coal production that will likely reduce profits for energy companies operating in the region. It is anticipated that the tax will raise \$293 million for Xinjiang Province. The Xingjiang resources tax is viewed as a pilot for a tax to be imposed nationally. The tax is based on volume as opposed to value which has been viewed positively by energy firms operating in the region.

USING TAXES TO SAVE THE ENVIRONMENT

The State Administration of Taxation (SAT) has declared its support for using tax policy to promote energy conservation. In Guoshuihan [2010] No. 180 ("Circular 180") the SAT indicated tax authorities all levels are required to understand how tax can be utilised to promote energy conservation. The SAT has issued a number of policies aimed at promoting the environment and in Circular 180 requires that these policies be supported and implemented at all levels of the tax system. Circular 180 indicates that the SAT will undertake "spot-checks" to ensure that local authorities are meeting these obligations.

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Automotive and pharmaceutical industries to be target of anti-avoidance investigations

China Taxation News, the official newspaper under the State Administration of Taxation ("SAT") of China, has reported that the pharmaceutical and automotive industries will be the focus of the China tax authorities' anti-avoidance investigations in the 2010 financial year.

More attention in intangibles and other complex arrangements

As the world's most important manufacturing base, historically China's anti-avoidance enforcement has focused on transfer pricing of contract manufacturing operations, which predominantly involve tangible goods transactions. In recent years, as the Chinese tax authorities have obtained more experience, there has been a clear trend towards a greater emphasis on more complex transactions, such as intangible assets and services transactions, equity transfers, cost sharing arrangements, thin capitalization, controlled foreign corporation. Taxpayers should note that, under the China tax laws, intangible transactions are also subject to business tax. As a result, the transfer pricing of intangible transactions may also be scrutinized by the Chinese tax authorities from a business tax perspective.

Automotive and pharmaceutical companies under spotlight

Foreign-invested automotive and pharmaceutical companies typically have high volume of crossed-border licensing and servicing transactions, which is one of the possible reasons why the Chinese tax authorities have decided to focus on them in 2010. Another possible reason is that the China tax authorities are keen on developing transfer pricing analysis framework that could better reflect the special economic environment in China. This framework includes some ideas such as location savings, China market premium and local market intangibles. As the automotive and pharmaceutical sectors are subject to stringent industrial regulations, the economic environment faced by companies operating inside China are arguably different from that faced by companies operating outside China. Therefore, the China tax authorities may perceive the two industries could provide good opportunities for exploring the above ideas. Regardless of the motivations behind this move, it is important for companies operating in these two industries to ensure that their tax affairs are in good order for 2010.

CLARIFICATION OF TAX INCENTIVES FOR SMALL PROFIT ENTERPRISES

On 14 May 2010 the State Administration of Taxation ("SAT") issued a circular clarifying the application of the tax preference for small-scale enterprises in respect of the 2010 year.

Under Guoshuihan [2010] No. 185 enterprises can enjoy a tax exemption of 15 percent of gross profit if the previous year's taxable income was less than RMB30,000, they meet requisite asset standards and the number of employees of the enterprise is consistent with small, low-profit enterprises.

Furthermore, when applying for the exemption, enterprises are required to provide the previous year's tax payment record to the tax authorities. The tax authorities will verify the qualifications accordingly, and those who no longer meet the standards will have to pay the tax exemptions back at the annual audit check.

The continues China's trend to provide significant tax benefits for low-profit enterprises and ameliorates the otherwise harsh impact on such enterprises of adopting a flat rate of corporate tax. This provides an additional incentive for individual traders to adopt the corporate form.



A PROPERTY TAX IN CHINA? – BACKGROUND TO THE DEBATE AND PROPOSED MODELS

Over the first half of 2010 the introduction of a property holding tax has dominated political discussion in China. This is not an entirely new development – such a tax being first considered in 2003. In recent years, several cities throughout China implemented a simulation scheme for such a tax – although tax was never actually collected. The proposed property tax has been raised amidst a discussion on the affordability of housing in China and the belief that a property tax would reduce the incentives for the speculative practices that have seen housing prices rise to the present levels.

An annual property holding tax is just response to this problem. In December 2009, the government reintroduced property sales tax of 5.5% on properties sold within 5 years of purchase.¹ Throughout the beginning of 2010 several measures have been introduced to “cool-down” the market as follows:

1. On 7 January 2010 the General Office of the State Council issued *Circular on Promoting the Steady and Healthy Development of the Property Market* (Circular 4/2010). The main purpose of Circular 4/2010 was to address the use of financing to acquire property. In particular, it required a 30% deposit for purchases of a first residential property and a 40% deposit for a purchase of a second residential property.
2. On 8 March 2010 the *Circular on Issues Relevant to Strengthening the Supply and Regulation of Land Use for Real Estate* was issued by the Ministry for Land and Resources requiring developers to pay a deposit of 20% to tax part in land auctions, make a 50% down payment for purchases of land within a month of signing the contract and to commence construction within a year of purchasing the land.¹
3. On 13 April 2010, the *Circular on Issues Relevant to Strengthening the Regulation of Real Estate Market and Improving the Pre-sale System of Commodity Property* was issued by the Ministry of Housing and Urban-Rural Development under which developers are not permitted without approval to pre-sell residential units, are required to publish the approved price within a specified timeframe and a time limit is imposed for the conclusion of a contract between a developer and a buyer.¹
4. On 20 April 2010 the State Council issued *Circular on Resolutely Curbing the Property Prices in Some Cities from Rapid Increase* (“Circular 10/2010”). Circular 10/2010 expanded upon and modified the measures in Circular 4/2010. In particular, it increased the required deposit for purchases of a second residential property to 50% and it indicate that commercial banks were entitled to reject loans for purchases of a third residential property.¹

It should be noted that these measures were introduced at a central government level. However, responsibility for the implementation of the measures lies with local governments. As a result, the implementation differs widely from jurisdiction to jurisdiction - a very common feature of the current regulation of land in China. A further, and potentially bigger, problem is that there is disagreement between the objectives of the central and local governments in this area. Local governments in China are currently suffering from a vertical fiscal imbalance and, accordingly, the central government push for a reduction in prices is contrary to the interests of the local governments who have a financial interest in the sale of (cont p. 5)



A PROPERTY TAX IN CHINA? – UNDERSTANDING THE DEBATE

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land to developers. It is on this basis that local governments prefer the introduction of a property holding tax with the majority of revenue to be collected by them.

Whilst there has been support for a tax at provincial and city levels, there has been resistance at a central level. Pan Shiyi, owner of the SOHO China group and one of the wealthiest people in China, commented in March, that “[t]he ones who have properties are the ones with the power to implement the tax”, inferring that therefore such a tax was unlikely to be introduced. Despite previous resistance or failure to act at a national level, it seems that the tide of discontent with the present affordability of housing in China is forcing the hands of the leaders in Beijing. However, the announcement of pilot scheme for the five cities in April 2010 does not necessarily mean that the scheme will be implemented with officials, whilst stating they are preparing for the scheme, being equivocal as to whether it will ultimately go ahead. The discord between support and opposition for such a tax, it has been suggested, reflects competing factions within China's political elite – one of which is comprised of China's wealthy and business elite, the other which is comprised of those who seek a rebalancing of the economy so that more share in China's recent economic success. These are important considerations to note because they demonstrate that, although China is a one party state and largely undemocratic, political discourse is still pluralistic and political leaders still seek to respond to community views. It is unequivocal that, despite China lacking formal democracy, community views are not irrelevant when making political decisions.

The Policy Motivations

There have been four principal bases on which a property holding tax has been advocated:

1. to cool-down the property market by removing speculative practices;
2. to increase the costs of holding property for the wealthy;
3. to address the general problem of housing affordability;
4. as a source of additional revenue for local governments that are presently struggling from a vertical fiscal imbalance and to address present concerns with the practices of local land sales.

Proposed Models

The precise nature or design of the proposed property tax is not yet clear. Chongqing, one of the cities in which the pilot scheme is intended to be trialled, has given its indication of what the property tax should look like a 1% on the value of any home over 200 square meters that was sold for three times the average market price, with a progressive scale up 5% of the price. (cont p. 6)



A PROPERTY TAX IN CHINA? – UNDERSTANDING THE DEBATE

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Other indications have suggested that the national government simply intends to extend Real Estate Tax, a tax previously applying only to commercial properties to residential properties with an adjustment to the relevant tax rates. Real Estate Tax is calculated in accordance with the “residual value” of the property – the original value of the property with a deduction of between 10 to 30 per cent. The appropriate deduction amount is determined by provincial and local governments. The residual value is then subject to tax at 1.2%. Alternatively, a tax of 12% of the rental income from the property is imposed. It has been suggested that the tax would only operate once a person owns at least three properties.

The Chinese Academy of Social Sciences (“CASS”) has proposed an alternative model under which developers would pay tax on unused and unsold land and property owners would pay an “ownership tax” based on the size and number of properties similar to the Chongqing Model. The CASS also proposes that principal residences be exempt from the tax, subject to certain limitations. An important component of the CASS Model is the removal other property transactional taxes as a part of the introduction of the property holding tax.

Conclusion

The introduction of a property holding tax has, assuming it is designed appropriately, merit. However, it is unlikely to address long-term housing affordability and may not even assist in cooling down the property market in the short term. What it does have the potential to do is address the persistent problem of vertical fiscal imbalance in relation to local governments in China and this should be viewed as the true purpose of the tax. That being said, if it is introduced as part of wide-ranging reforms of current land sale practices in China, as is envisaged by some, it may indirectly lead to a reduction in property prices. However, a property holding tax should not be seen a substitute for the appropriate economic reform required to rebalance China's rapid economic development

Hwuason promises to keep you abreast of the latest developments in China's tax laws to ensure that you are aware of fresh opportunities.

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