

Tax Implications of Doing Business in China

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PRÉCIS

Depuis 1979, la Chine a établi un régime fiscal étendu. Les sociétés canadiennes qui font affaire en Chine sont actuellement assujetties à des impôts sur le revenu, à des taxes de vente, à des impôts fonciers et à différentes autres taxes. Le présent article a pour but d'examiner l'incidence de ces taxes et impôts sur les sociétés canadiennes.

La première partie de l'article porte sur l'importance de la planification fiscale des investissements en Chine et sur certains éléments de planification uniques à ce pays.

Dans la deuxième partie, l'auteur fait un survol de la structure fiscale visant les entreprises étrangères. Il examine plus particulièrement l'impôt sur le revenu des particuliers, l'impôt sur le revenu des entreprises de placement étranger et des entreprises étrangères, la taxe sur la valeur ajoutée, la taxe d'affaires, la taxe à la consommation et différents impôts fonciers et autres taxes. L'auteur examine également l'incidence de la convention fiscale entre le Canada et la Chine sur les entreprises qui font affaire en Chine.

La troisième partie traite de l'incidence fiscale associée aux diverses structures ou aux différents arrangements d'entreprises, notamment à l'égard de l'exportation des produits et des services, des projets donnés en sous-traitance, de l'exploitation par une succursale, des transferts de technologie, des coentreprises avec participation au capital, de coopération et contractuelles, des entreprises détenues exclusivement par des étrangers et des sociétés de portefeuille.

ABSTRACT

Beginning in 1979, China has established an extensive tax system. Canadian companies doing business in China are currently subject to income taxes, sales taxes, property taxes, and various other taxes. This article examines the implications of these taxes for Canadian companies.

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The first part of the article highlights the importance of tax planning for investment in China and identifies some planning considerations unique to the country.

The second part provides an overview of the Chinese tax structure for foreign business. In particular, the author discusses the individual income tax, the income tax on foreign investment enterprises and foreign enterprises, the value-added tax, the business tax, the consumption tax, and an assortment of property and other taxes. The author also considers the impact of the Canada-China tax treaty on Canadian businesses in China.

The third part of the article analyzes the tax implications associated with various business structures or arrangements, such as the export of goods and services, contracted projects, branch operations, transfers of technology, equity joint ventures, cooperative or contractual joint ventures, wholly foreign-owned enterprises, and holding companies.

INTRODUCTION

Since 1979, China has established an extensive and complex tax system. Canadian companies with an interest in doing business in China now face a situation similar to that encountered in other foreign jurisdictions: a variety of business and investment vehicles are available, each with different tax consequences, so that opportunities exist for tax planning.

Tax planning is not just desirable but essential. Although all types of foreign investment enterprise receive the same basic tax treatment, there are great differences depending on the nature of the enterprise and its location. Tax planning is also feasible. Initially, when China had just issued the new tax laws for foreign business, foreigners had no choice but to speculate on the tax treatment of specific transactions, with only the general and imprecise language of the statutes as a guide. Over the past decade, this state of uncertainty has given way to a set of more extensive and detailed legislation and a body of cumulative experience in the tax administration. While some fundamental questions remain unanswered, the tax consequences of common transactions can now be determined with a degree of accuracy not previously possible.

In planning activities in China, a Canadian company should not necessarily seek always to minimize or eliminate its Chinese tax; it should evaluate potential benefits such as the goodwill and increased business opportunities that might accrue from contributing to the Chinese fisc. A history of paying little or no tax, even if completely legal, may stigmatize a company and ultimately prove detrimental to its long-term interests in China.

Tax planning in China is not without difficulties. Despite the introduction of more detailed legislation in recent years, much of Chinese tax law is drafted in language that is general and sometimes imprecise, so that a literal interpretation is virtually impossible. The Chinese do not necessarily interpret their tax laws in the same manner as western-trained lawyers.

Rigorous statutory construction, no matter how logically impeccable or internally consistent, may not always be persuasive in dealings with tax officials; nor will it always be useful to western advisers in predicting the tax treatment of a particular business transaction. Under Chinese law, it is the tax administration rather than the courts that have the general power of statutory interpretation. In addition, local tax authorities often apply their own interpretation of tax legislation. As a result, foreign investors may be affected quite differently by the same statute, depending on where they locate their investment. It is not uncommon to find that the “real law,” based on the practice and interpretation of the tax authorities, is different from that implied by the wording of a statute. Finally, the Chinese do not generally accept the concept of tax planning as it is understood and applied in western countries. Tax planning to obtain advantages intentionally offered by the Chinese tax laws is blessed by the tax authorities, but other types of planning could be deemed to be tax evasion or fraud. The Chinese generally do not distinguish between tax avoidance and tax evasion.

This article examines how the Chinese tax system affects Canadian companies doing business in China. It presents first an overview of the Chinese tax structure for foreign business and then an analysis of the tax implications associated with various business structures or arrangements.

OVERVIEW OF THE CHINESE TAX STRUCTURE

The Basic Tax Structure

Major taxes that affect foreigners doing business in China are the individual income tax (the IIT),¹ the income tax on foreign investment enterprises and foreign enterprises (the FIT),² the value-added tax (VAT),³

¹ Individual Income Tax Law of the People's Republic of China, adopted by the 3rd Session of the 5th National People's Congress on September 10, 1980, amended on October 31, 1993 by the 4th Session of the 8th National People's Congress, and effective on January 1, 1994 (herein referred to as “the IIT law”); and Implementing Regulations for the Individual Income Tax Law of the People's Republic of China, issued by the State Council on January 29, 1994 (herein referred to as “the IIT regulations”). See Jinyan Li, “The Tax Position of Foreigners in China Under the New Individual Income Tax Law” (December 13, 1993), 7 *Tax Notes International* 1495-1505 and “The Impact on Foreigners of China's Implementing Regulations for the New Individual Income Tax Law” (April 4, 1994), 8 *Tax Notes International* 939-45; and Timothy A. Gelatt, “China's New Individual Tax Law: Implications for Foreign Business” (November 15, 1993), 15 *East Asian Executive Reports* 7-11.

² Income Tax Law of the People's Republic of China Concerning Foreign Investment Enterprises and Foreign Enterprises, adopted by the 4th Session of the 7th National People's Congress on April 9, 1991 (herein referred to as “the FIT law”); and Detailed Regulations for the Implementation of the Income Tax Law of the People's Republic of China Concerning Foreign Investment Enterprises and Foreign Enterprises, promulgated by the State Council on June 30, 1991 (herein referred to as “the FIT regulations”). For further details, see Stephen M. Nelson, “New Unified Tax Law Governing Foreign Investment Enterprises and Foreign Companies” (June 1991), 3 *Tax Notes International* 605-13 and “China Issues Detailed Implementing Rules for New Unified Tax Law” (October 1991), 3 *Tax Notes International* 1058-61, “. . . Part II” (December 1991), 3 *Tax Notes* (2, 3 Continued on the next page.)

the consumption tax,⁴ and the business tax.⁵ In addition, China has concluded more than 40 tax treaties, including one with Canada.⁶ These treaties are based on the OECD model convention and the United Nations model convention; they apply to both the IIT and the FIT.

Unlike Canada, China is a unitary state; only the national government has the power to introduce income and sales taxes. The State Tax Administration (STA) administers the national tax laws and regulations. The STA does not, however, collect any taxes; taxes are collected by tax bureaus at provincial and local levels. To ensure consistent implementation across the country, the STA issues tax policy statements, interpretation notices, and, sometimes, advance tax rulings.

Taxpayers are encouraged to resolve their disputes with the tax authorities through administrative review, and most disputes are resolved this way. The absence of litigation may reflect, at least in part, a traditional Chinese preference for resolving disputes informally. More likely, however, it stems from the fact that Chinese tax legislation expressly gives a broad measure of discretion to local tax authorities, especially with respect to qualifications for preferential tax treatment and the use of the alternative methods of computing profits. Since these matters fall within the discretion of the bureau, taxpayers normally have little to gain

2, 3 Continued . . .

International 1288-90, and “. . . Part III” (February 1992), 4 *Tax Notes International* 211-14; Timothy A. Gelatt, “China’s New Tax Law for Foreign Business: A Rational System Emerges” (May 15, 1991), 13 *East Asian Executive Reports* 9-14; and Jinyan Li, “People’s Republic of China: The Implementing Regulations for the New Consolidated Income Tax on Foreign Investment” (April 1992), 46 *Bulletin for International Fiscal Documentation* 170-80.

³ Provisional Regulations of the People’s Republic of China on Value-Added Tax adopted by the State Council on November 26, 1993 and promulgated on December 13, 1993 (herein referred to as “the VAT law”); and Detailed Rules for the Implementation of the Provisional Regulations of the People’s Republic of China on Value-Added Tax, issued by the Ministry of Finance on December 25, 1993 (herein referred to as “the VAT regulations”). See Jinyan Li, “The Impact of the New Sales Taxes on Foreign Investment in China” (April 18, 1994), 8 *Tax Notes International* 1075-87.

⁴ Provisional Regulations of the People’s Republic of China on Consumption Tax, adopted by the State Council on November 26, 1993 and promulgated on December 13, 1993 (herein referred to as “the consumption tax law”); and Detailed Rules for the Implementation of the Provisional Regulations of the People’s Republic of China on Consumption Tax, issued by the Ministry of Finance on December 25, 1993 (herein referred to as “the consumption tax regulations”).

⁵ Provisional Regulations of the People’s Republic of China on Business Tax, adopted by the State Council on November 26, 1993 and promulgated on December 13, 1993 (herein referred to as “the business tax law”); and Detailed Rules for the Implementation of the Provisional Regulations of the People’s Republic of China on Business Tax, issued by the Ministry of Finance on December 25, 1993 (herein referred to as “the business tax regulations”).

⁶ Agreement Between the Government of Canada and the Government of the People’s Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Beijing on May 12, 1986 (herein referred to as “the Canada-China treaty”). The treaty entered into force on January 1, 1987.

in challenging an adverse decision, and there is a tendency to regard the legislation as a set of flexible guidelines rather than fixed rules. A friendly working relationship with the local tax bureau is generally to the taxpayer's benefit.

Individual Income Tax

The IIT was introduced in 1980 and amended in 1993.⁷ It is a schedular tax—that is, different types of income attract different tax liability.

Taxpayers

Under the IIT, individuals are liable to tax if they are domiciled in China, reside in China, or derive income from Chinese sources.

Domicile

Individuals domiciled in China are liable to tax on their worldwide income. Individuals are deemed to be domiciled in China if they habitually live in China because of household registration, family, or economic interests.⁸ These individuals include Chinese citizens with their household registration in China and foreigners who make China their permanent home instead of a place of work or temporary stay. Very few foreigners receive permanent resident status in China; most are issued a visa or residence permit to visit or stay temporarily in China.

Residency

“Residency” generally means “physical stay.”⁹ Foreigners who reside in China for one year or more are liable to IIT on their worldwide income; individuals who never visit China or who stay in China for less than one year are liable to IIT only on their Chinese source income (the “one-year rule”). Individuals are considered to have resided in China for one year if they have stayed in China for 365 days in a taxation year.¹⁰ In calculating the period of stay, no subtraction is allowed for temporary absences from China. “Temporary absences” refers to absences not exceeding 30 days at any one time, or in the aggregate not exceeding 90 days in a taxation year.¹¹

⁷The new IIT consolidated three existing taxes: the IIT (1980), applicable mostly to foreigners; the individual income regulatory tax (1986), applicable to Chinese citizens; and the household income tax (1986), applicable to business income earned by individuals and households. For a discussion of these taxes, see A.J. Easson and Jinyan Li, *Taxation of Foreign Investment in the People's Republic of China* (Deventer, the Netherlands: Kluwer, 1989), chapter 3; and Jinyan Li, *Taxation in the People's Republic of China* (New York: Praeger, 1991), 83-87.

⁸IIT regulations, article 2.

⁹The period of residency is calculated by counting the number of days of actual presence in China. Where a taxpayer's stay in China straddles two taxation years, the stay for each year is calculated separately.

¹⁰A taxation year is defined as a calendar year: IIT regulations, articles 3 and 44.

¹¹IIT regulations, article 3.

There are two exceptions to the one-year rule. The first exception applies to individuals who stay in China for one year or more, but not more than five years. These individuals are exempt from tax on their foreign source income if the income is paid by a non-resident of China and the exemption is approved by local tax authorities. Therefore, foreigners are subject to worldwide taxation in China only if they stay in China for more than five years.¹² Another exception applies to individuals who reside in China for an aggregate of 90 days or less during a taxation year (the “90-day rule”). These individuals are exempt from tax on wage or salary income received from a foreign enterprise for services performed in China, provided that the payment is not borne by an employer’s establishment in China.¹³ The 90-day rule is commonly extended to a 183-day rule by tax treaty. Under the Canada-China treaty, for example, if an employee of a Canadian company is not present in China for more than 183 days in a calendar year, his or her salary is not taxable in China unless the company’s permanent establishment in China deducts it as an expense in computing its profits for Chinese income tax purposes.¹⁴ The 90-day rule will therefore apply only to residents of countries or regions that do not have treaties with China, such as Hong Kong, Taiwan, and Macao.

Non-Residents

Non-residents are subject to the IIT only on income earned from Chinese sources. Non-residents include individuals who do not visit China or who stay in China for less than a year. Chinese source income includes

- employment income from services rendered in China;
- rent for the use of property in China;
- gains from the transfer of property in China;
- royalties for the use of proprietary rights in China;
- interest from individuals, companies, and other economic organizations in China; and
- dividends from companies in China.

Chinese source income is considered to have been “gained” in China regardless of whether actual payments are made in China or abroad.

¹² Unlike earlier legislation, this rule applies irrespective of the reason for the long-term residency. Under the previous IIT, foreign source income was exempt from tax if a foreigner’s presence was attributable to his or her employment with a foreign investment enterprise and if the individual had no general intention to take up long-term residency in China. See Ministry of Finance Notice Regarding the Exemption from Reporting and Payment of Individual Income Tax for Income Gained Outside China by Personnel of Foreign Nationality Working in China, *Cai Shui Zi* no. 62, March 7, 1983.

¹³ IIT regulations, article 7.

¹⁴ Canada-China treaty, article 16.

Taxable Income and Rates

The IIT is imposed on 11 categories of income. Each category of income is computed and taxed separately. Some categories are taxed at progressive rates, and others at a flat rate.

Wages and Salaries

“Wages and salaries” include bonuses, year-end extras,¹⁵ benefits, allowances, and other income earned by an individual from employment or office. “Benefits” and “allowances” are undefined. The meaning of these concepts is left to be clarified by the tax administration.

Over the years, the Chinese tax authorities have developed guidelines on the taxability of various fringe benefits and allowances received by foreigners working in China from their employers for housing, meals, relocation, home leave, family education, hardship allowances, and the like. Although not entirely uniform and satisfactory, the administrative guidelines have enabled companies to arrange “remuneration packages” for their employees. For example, certain expenses paid directly by the employer or paid by the employee and reimbursed by the employer are normally not taxable benefits to the employee.¹⁶ Such expenses include costs of housing or accommodation,¹⁷ travelling costs to return home on leave, relocation or moving costs, local transportation, housekeeping expenses, and meals. Similarly, contributions made by employers to pension plans, dental plans, or insurance plans on behalf of employees are not considered to be taxable benefits to the employee.¹⁸

In contrast, where an employee receives a cash “allowance” on a per diem or monthly basis, the allowance is normally deemed to be part of salary. For example, overseas allowances or family allowances to cover the employee’s expenses on home visit while working in China are clearly

¹⁵ Because wages and salaries are taxed on a monthly basis at progressive rates, the inclusion of bonuses in the definition of “wages and salaries” can result in a year-end or other occasional bonus being taxed more heavily than if the same amount had been paid evenly over the year. To avoid this result, a form of income averaging is allowed in practice. Ministry of Finance Notice, *Shui Wai Bian Zi* no. 65, July 17, 1981.

¹⁶ The employer must submit “proof” that has been verified by the local tax authorities. This “proof” must establish that the payments were for “company expenses” and not for food, laundry, or other personal expenses of the employee, and were not part of the employee’s salary.

¹⁷ In the case of employer-provided housing allowances, the employee must take the allowance into income but may deduct the actual amount used for housing if he or she can support the deduction with receipts. See Ministry of Finance Notice, *Cai Shui Wai Zi* no. 21, January 20, 1988.

¹⁸ Where part of an employee’s salary is used to buy stock of the employer, the employee is not taxed on this amount if the employer does not deduct it as an expense. See State Tax Bureau Notice, *Guo Shui Han Fa* no. 67, January 19, 1990. (The name of the tax administration has been changed over the past few years from the State General Bureau of Taxation to the State Tax Bureau and recently to the State Tax Administration. Since most of the interpretation notices were issued before the most recent change, the name State Tax Bureau or STB will be used in the notes.)

taxable. Because the IIT law does not permit any deductions from wages and salaries, other than a standard deduction, few employers pay taxable allowances to their employees. Instead, the employer either pays such expenses directly or reimburses the employee for expenses actually incurred as supported by vouchers. Furthermore, the payment of income tax by employers for an employee is regarded as taxable remuneration; the employee is consequently taxed on the grossed-up amount.¹⁹

Income from wages or salary is taxed at progressive rates ranging from 5 percent to 45 percent. Tax liability on employment income is computed monthly. The 45 percent rate applies to a monthly taxable income of RMB 100,000 (US\$11,494).²⁰ In calculating taxable income, taxpayers may deduct a monthly sum of RMB 800 (US\$92). This deduction can be regarded as an allowance for "cost of living," but it is not adjusted for inflation.²¹ Because of inflation and devaluation of the Chinese currency, the cost of living for expatriates has been increasing; to provide some relief, the IIT regulations allow expatriates an additional deduction of RMB 3200 (US\$368).²²

Business Income and Management Fees

Income from carrying on industrial and commercial activities²³ and from management fees²⁴ is taxable annually at progressive rates ranging from 5 percent to 35 percent. In computing taxable income, deductions may be claimed for related costs, expenses, and losses. For management fees, the annual deduction for expenses is limited to a statutory amount of RMB 9600 rather than actual business expenses.²⁵ Foreign individuals are unlikely to earn these types of income at present.

¹⁹ Ministry of Finance Notice, *Cai Shui Wai Zi* no. 34, February 18, 1986.

²⁰ When the IIT law was introduced in December 1993, the official exchange rate was US\$1 = RMB 5.8, while the market rate was about US\$1 = RMB 8.8. On January 1, 1994, China implemented a single controlled foreign exchange floating rate in line with the longstanding swap market rate. Since then, the exchange rate has been hovering around US\$1 = RMB 8.6.

²¹ Where an individual is employed for less than a month, the full deduction of RMB 800 has been permitted. See Ministry of Finance Notices, *Cai Shui Zi* no. 185, June 2, 1981 and *Cai Shui Wai Zi* no. 60, July 7, 1981. In cases where the salary is paid by the employer for the entire month, the salary is apportioned on a per diem basis according to the number of days of stay in China.

²² IIT law, article 6. Similar deductions may be allowed for Chinese citizens deriving employment income from foreign countries.

²³ "Business income" refers to income derived by Chinese entrepreneurs: IIT regulations, article 8(2).

²⁴ "Management fees" refers to compensation in the nature of salaries or wages paid on a monthly basis (or according to each management project) for managing the business of the enterprise or institution: IIT regulations, article 8(3).

²⁵ IIT regulations, article 18.

Remuneration for Personal Services

Personal services include services provided by accountants, lawyers, medical doctors, engineers, architects, entertainers, and other professionals.²⁶ Unlike income from employment or business, income from remuneration for personal services is taxable at a flat rate of 20 percent on a single-payment basis. Where the taxable income from a particular payment exceeds RMB20,000, a surtax is imposed at 50 percent or 100 percent of the regular tax. The combined rate is thus 30 percent on the amount between RMB20,000 and RMB50,000 and 40 percent on any amount exceeding RMB50,000.²⁷ A single payment means income from a lump-sum payment for personal services, payment from performing a single piece of work, or payment received within a month for work of a continuing nature. In computing taxable income from each single payment, taxpayers may deduct the lesser of RMB800 and 20 percent of the payment.²⁸

Under the IIT, remuneration for personal services in China is taxable irrespective of the place of payment. Foreign individuals who provide services to Chinese enterprises in China normally receive payments directly from the Chinese enterprise. In some cases, they may be paid indirectly by a company outside China. For example, a Canadian company that sells machinery to a Chinese enterprise may agree to provide installation and maintenance services, or training for the Chinese operators, and send a self-employed Canadian technician to provide those services. In such cases, the Chinese tax authorities generally treat the fee as the technician's Chinese source income and tax it accordingly.²⁹ Under the Canada-China treaty, however, professional income is taxable in China only if the recipient is present in China for more than 183 days in a calendar year or has a fixed base in China. Special exemptions are provided in the case of athletes and entertainers.³⁰

Rents and Royalties

Rents and royalties are taxed at a flat rate of 20 percent.³¹ "Rental income" refers to income from the lease of buildings, land-use rights, machinery and equipment, vehicles, vessels, and other property. Royalties

²⁶ Other services include designing, decorating, installation, consulting, lecturing, news reporting, broadcasting, editing, calligraphy, painting, recording, art performance, advertising, exhibitions, technical services, agency, and brokerage: IIT regulations, article 8(4).

²⁷ IIT regulations, article 11.

²⁸ For a single payment of RMB4,000 or less, the deduction is RMB800; for a single payment exceeding RMB4,000, the deduction is 20 percent of the payment: IIT law, article 6(4).

²⁹ Ministry of Finance Notices, *Cai Shui Zi* no. 214, November 20, 1980 and *Cai Shui Zi* no. 56, February 26, 1981.

³⁰ Canada-China treaty, articles 14 and 17.

³¹ IIT law, article 3(5). This rate is reduced to 10 percent under the Canada-China treaty.

include both authors' royalties³² and royalties for the transfer or licence of technology or other proprietary rights such as patents, trademarks, copyright, and knowhow. Tax is computed on a single-payment basis;³³ taxpayers may claim a statutory deduction of the lesser of RMB 800 and 20 percent of each payment, but not costs and expense.³⁴

Interest and Dividends

Interest and dividend income is taxed at a flat rate of 20 percent of the gross amount.³⁵ No deduction is allowed for carrying charges and other costs of earning such income. Certain types of interest, such as interest on savings deposits, government bonds, and financial bonds issued by the government, are exempt from tax.³⁶ Dividends paid by Chinese-foreign joint ventures or wholly foreign-owned enterprises also are exempt from tax.³⁷ It is unclear whether dividends paid on shares of other enterprises are exempt from tax.³⁸

Capital Gains

Net gains are taxable at a flat rate of 20 percent if they are derived from the transfer of capital property such as buildings, machinery and equipment, land-use rights,³⁹ shares,⁴⁰ and bonds. The amount of a net gain is

³² IIT regulations, article 8(5). "Authors' royalties" refers to remuneration for publishing literary works.

³³ A "single payment" for rental income refers to income from amounts paid within a month for the use of the rental property. A "single payment for authors' royalties" is defined as income from each payment for each publication. A "single payment for fees for the use of proprietary rights" refers to income from a lump-sum payment for each transfer of the right to use proprietary rights. IIT regulations, article 21.

³⁴ In practice, the Chinese tax authorities may allow deductions for property taxes, maintenance, and repair costs. See State Tax Bureau Notice, *Guo Shui Han Fa* no. 1236, October 10, 1990.

³⁵ The rate is reduced under articles 10 and 11 of the Canada-China treaty to 10 percent for interest and dividends.

³⁶ IIT law, article 4(2); and IIT regulations, article 12.

³⁷ FIT law, article 19(1).

³⁸ It has been reported that non-residents who purchased shares of Chinese companies through the Hong Kong stock exchange were exempt from the 20 percent withholding tax under the previous IIT regime. See *South China Sunday Morning Post* (China Business Review), September 26, 1993, 1. Since the establishment of a securities exchange in Shanghai and Shenzhen in 1990 and 1991, there has been a rapid increase in foreign investment in bonds and B shares issued by Chinese companies. B shares are shares denominated in *renminbi* and offered exclusively to foreign investors for purchase and sale with foreign exchange. B shares are traded at the Shanghai and Shenzhen stock exchange. Some Chinese companies have recently issued shares outside China, especially in Hong Kong and New York (the so-called H shares).

³⁹ The Chinese constitution prohibits the transfer of land that is owned by the state or collectives, but land-use rights can be transferred.

⁴⁰ Gains from the transfer of shares and real estate may be taxed separately: IIT regulations, article 9.

equal to the proceeds of disposition less the original cost of the property and reasonable expenses.

Incidental Income and Other Income

“Incidental income” and “other income” are taxed at 20 percent of the gross amount. “Incidental income” includes awards, lottery winnings, and other incidental income; “other income” is to be defined by the Ministry of Finance.

Foreign Tax Credit

Where taxpayers include foreign source income in their Chinese income, they may claim a credit for income taxes paid abroad on that income. The credit cannot exceed the amount of Chinese tax otherwise payable on the income derived from a particular country.

Tax Administration

IIT is generally withheld by payers of income and remitted to the government within the first seven days of the following month. Withholding agents must file returns and are paid a 2 percent service fee. IIT on business income and management fees is levied on an annual basis and paid in monthly instalments.

Foreign Income Tax

The FIT law of 1991 consolidated the joint venture income tax of 1980,⁴¹ applicable to equity joint ventures, and the foreign enterprise income tax of 1981,⁴² applicable to other forms of foreign investment. The FIT also incorporated various special regulations that provide incentives to taxpayers in special areas or industries, as well as a body of administrative rulings and practices.⁴³ The FIT law and its implementing regulations do not, however, purport to represent the whole of China’s tax regime for foreign business and investment. Many specific regulations governing issues such as the transfer of technology, lending, and leasing remain in

⁴¹ Income Tax Law of the People’s Republic of China Concerning Joint Ventures Using Chinese and Foreign Investment, passed by the National People’s Congress on September 10, 1980. The implementing regulations for this law were promulgated by the Ministry of Finance on December 14, 1980.

⁴² The Income Tax Law of the People’s Republic of China Concerning Foreign Enterprises, passed by the National People’s Congress on December 13, 1981. The implementing regulations for this law were promulgated by the Ministry of Finance on February 21, 1982.

⁴³ Previously issued regulations or administrative rulings are still in effect unless they have been officially cancelled or are inconsistent with the provisions of the FIT law and regulations. See Ministry of Finance Notice, *Cai Shui Zi* no. 16, August 22, 1992; State Tax Bureau Notice on Cancellation of Some Provisions Issued Prior to July 1, 1991 Regarding the Computation and Levy of Income Tax on Foreign Investment Enterprises and Foreign Enterprises, *Guo Shui Fa* no. 201, August 27, 1992; and State Tax Bureau Notice on Publishing a List of Cancelled or Expired Regulations, *Guo Shui Fa* no. 278, November 30, 1992.

force. Moreover, although the FIT law refers generally to tax incentives, investors may still need to refer to the relevant legislation for details of these incentives.

Taxpayers

The FIT applies to “foreign investment enterprises” (FIEs) and foreign enterprises doing business in China or earning income from China. FIEs are subject to tax on their worldwide income, whereas foreign enterprises are taxable only on their Chinese source income.

Foreign Investment Enterprises

FIEs include Chinese-foreign equity joint ventures,⁴⁴ cooperative (or contractual) joint ventures,⁴⁵ and wholly foreign-owned enterprises.⁴⁶ FIEs pay tax on their worldwide income if they maintain a head office in China⁴⁷ and have the status of a legal person.

Equity joint ventures and wholly foreign-owned enterprises are legal persons under Chinese law.⁴⁸ A cooperative joint venture may or may not be incorporated as a legal person.⁴⁹ If a cooperative joint venture takes the form of a contractual arrangement or partnership, the venture is not a separate taxpayer. Rather, the parties to the venture pay tax separately, and the venture is deemed to be an establishment of the foreign party. In some cases, however, with the approval of the tax authorities, the parties may elect to have the venture taxed as a single entity.⁵⁰ If a cooperative

⁴⁴ Equity joint ventures are established under the Law of the People’s Republic of China Concerning Joint Ventures Using Chinese and Foreign Investment, adopted by the National People’s Congress on July 1, 1979 and amended on April 4, 1990 (herein referred to as “the EJV law”); and Detailed Rules and Regulations for the Implementation of the Law of the People’s Republic of China Concerning Joint Ventures Using Chinese and Foreign Investment, issued by the State Council on September 20, 1983.

⁴⁵ Cooperative (contractual) joint ventures may be established under the Law of the People’s Republic of China Concerning Chinese-Foreign Cooperative Joint Ventures, passed by the National People’s Congress on April 13, 1988 (herein referred to as “the CJV law”). No implementing regulations have been introduced for this law.

⁴⁶ Wholly foreign-owned enterprises are established under the Law of the People’s Republic of China Concerning Enterprises Operated Exclusively with Foreign Capital, passed by the National People’s Congress on April 12, 1986 (herein referred to as “the WFOE law”); and Detailed Rules for the Implementation of the Law of the People’s Republic of China Concerning Enterprises Operated Exclusively with Foreign Capital, issued by the State Council on September 12, 1990.

⁴⁷ “Head office” refers to a central organization set up in China by a FIE to be responsible for the operations, management, and control of the enterprise: FIT regulations, article 5.

⁴⁸ An enterprise is a legal person if it is established in accordance with Chinese law; possesses the necessary property or funds; has its own name, organizational structure, and premises; and is able to assume civil obligations independently. See General Provisions of the Civil Law of the People’s Republic of China, adopted by the National People’s Congress on April 12, 1986, article 4.

⁴⁹ CJV law, article 2.

⁵⁰ FIT regulations, article 7; State Tax Bureau Notice on Operational Problems in the Thorough Implementation of the Foreign Related Enterprise Income Tax Law, *Guo Shui Fa* no. 165, October 15, 1991, article 4.

joint venture is a legal person, or if the parties elect to have the venture treated as one entity, the venture is the taxpayer.

Foreign Enterprises

Foreign enterprises carrying on business in China through an “establishment” are taxable on the net income derived through the establishment at 33 percent. Foreign enterprises without establishments in China are taxable only on Chinese source investment income and capital gains at 20 percent of the gross income. The significant difference in tax treatment makes it critical for a foreign company to determine whether it has an “establishment.”

“Establishment” is defined as a “management office, business site, office, factory, place of extraction of natural resources, site for contracted projects such as construction, installation, assembly or exploration projects, site for the furnishing of services, and a business agent.”⁵¹ A business agent is deemed to be an establishment of a foreign company if the agent habitually negotiates and concludes purchase or sales contracts in the name of the company, or habitually stores the company’s goods and makes deliveries to third parties on behalf of the company.⁵²

Under the Canada-China treaty, Canadian companies are not taxable in China unless they carry on business through a “permanent establishment” in China. The concept of a “permanent establishment” has a narrower meaning than “establishment” in two main respects. First, the treaty distinguishes between dependent and independent agents, whereas the FIT law does not. Under the treaty, a dependent agent in China is deemed to be a permanent establishment of a Canadian company, but an independent agent is not, unless the agent is an exclusive agent and habitually exercises the power to conclude contracts for the Canadian company.⁵³ Second, a service project may be deemed to be an “establishment” for the purposes of the FIT regardless of the duration of the project, but the project is not a “permanent establishment” under the treaty unless it lasts more than six months.⁵⁴

Foreign enterprises without establishments in China are subject to withholding tax on Chinese source income. If, however, the earning of such income is “actually related” to a foreign enterprise’s establishment in China, regardless of whether it is derived within or outside China, the income is taxable as part of the establishment’s profits.⁵⁵ The meaning of “actually related” is unclear. Consider a case where a Canadian company

⁵¹ FIT regulations, article 3.

⁵² FIT regulations, article 4.

⁵³ Canada-China treaty, article 5(6).

⁵⁴ The Chinese tax administration’s posture suggests that “establishment” is not interpreted as broadly as the regulations might seem to allow, but rather in a manner akin to the concept of a “permanent establishment” within the meaning of the treaty.

⁵⁵ Similar provisions are contained in articles 10 to 12 of the Canada-China treaty.

has a representative office in Beijing and the Beijing representative is also responsible for the company's other East Asian business. The representative, while on a business trip to Tokyo, negotiates and signs a licensing agreement with a Japanese firm; royalties are payable to the company in Canada. Should the royalties from this Japanese contract be considered related to the Beijing office?⁵⁶ The answer to this question is unclear; there seems to be no indication as yet that the Chinese tax authorities will assess the representative office on the royalties.

Computation of Taxable Income

FIEs and foreign enterprises with establishments⁵⁷ in China pay tax on their "taxable income." "Taxable income" is the amount of income net of costs, expenses, and losses.⁵⁸

General Accounting Rules

The rules for calculating income largely follow internationally accepted accounting principles. A clear distinction is made between capital and revenue expenditures. Inventory must be taken at least once a year. Inventory is valued at actual cost, which is determined according to one of four methods: first in, first out (FIFO); moving average; weighted average; or last in, first out (LIFO). Once a method is chosen, a taxpayer may not change it without approval of the tax authorities.

Income is computed annually. A "taxation year" is normally the calendar year. In special cases, taxpayers may use their own 12-month fiscal period with the approval of the tax authorities. A short taxation year is allowed where the taxpayer commences or terminates its business during the year or where there is a reorganization of the enterprise. Income is generally recognized on an accrual basis. Taxpayers may defer the reporting of income where payments for goods and services are deferred to future years, or where the manufacturing of goods or the provision of services lasts more than one year.⁵⁹ Where parties to a cooperative joint venture share products instead of cash profits, each party is deemed to have realized income when products are received.

⁵⁶ The provision may be interpreted differently in different situations. Foreign taxes paid on non-Chinese income that is deemed to be related to the Chinese establishment, and hence taxable in China, may be deducted as business expenses in calculating Chinese taxable income: FIT regulations, article 28.

⁵⁷ Where a foreign enterprise has two or more establishments in China, it may, subject to approval by the tax authorities, designate one of the establishments to file returns and pay income tax on a consolidated basis: FIT regulations, article 92.

⁵⁸ FIT law, article 4.

⁵⁹ In the case of instalment payments, sales revenue may be recognized when goods are delivered, when the invoice is issued, or when payment becomes due. Where a construction, installation, or assembly project or the provision of services lasts more than one year, or the processing or manufacturing of machinery, equipment, or vessels lasts more than one year, revenue may be realized according to the portion of work completed during the year. FIT regulations, article 11.

Income Inclusions

Income of FIEs or foreign enterprises with establishments in China includes income from production or business,⁶⁰ investment income,⁶¹ and capital gains. Intercorporate dividends are excluded in computing the recipient's income. Capital gains are taxed in the same manner as business income; they include gains from the disposition of capital property, gains from the liquidation of a business,⁶² and foreign exchange gains derived in the course of carrying on business.

Deductions

In computing income, taxpayers may deduct expenses incurred in the course of carrying on business, such as the cost of goods sold, sales taxes, and marketing and administration fees. Article 19 of the FIT regulations prohibits the deduction of certain expenses, such as capital expenditures; income tax payments, fines, and penalties; and expenses unrelated to production and business operations.

Interest expense is deductible if the amount of the interest is reasonable.⁶³ An interest payment is considered reasonable if the rate is not higher than the rate for ordinary commercial loans. Interest expense incurred for acquiring fixed assets or intangible assets is not currently deductible but may be added to the cost of assets and amortized. The FIT law contains no rules on the debt-equity ratio of FIEs. In practice, when the debt-equity ratio of a FIE exceeds the ratio specified under other regulations, the Chinese tax authorities will deny the deduction of interest on any excessive debt.⁶⁴ The following debt-equity ratios are specified to prevent undercapitalization:⁶⁵

⁶⁰ "Production and business" refers to manufacturing, farming, transportation, construction trading, financing and services, and other trades: FIT regulations, article 2.

⁶¹ This type of income includes dividends; interest; rents; income from provision or assignment of the right to use patents, proprietary technology, trademarks, or copyright (royalties); and non-operating income: FIT law, article 1.

⁶² This is the net asset value of the remaining property: FIT law, article 18; and FIT regulations, article 29.

⁶³ FIT regulations, article 21. The deduction is subject to approval by the local tax authorities, to whom information concerning the loan and payment of interest must be provided.

⁶⁴ This is based on an interview of the author with a Chinese tax official on July 14, 1994.

⁶⁵ Interim Provisions Concerning the Ratio Between Registered Capital and Total Investment of Chinese-Foreign Equity Joint Ventures, issued on March 1, 1987 by the State Administration of Industry and Commerce. For the purposes of these provisions, "registered capital" refers to equity investment and "total investment" refers to the total cost of the project, including working capital, which is to be financed by a combination of debt and equity. These provisions were originally introduced to apply to equity joint ventures, but, in practice, cooperative joint ventures and wholly foreign-owned enterprises must meet the same standards.

- where the total investment (including both debt and equity) of a FIE is less than US\$3 million, the equity must be at least 70 percent of the total investment;
- where the total investment is between US\$3 million and US\$10 million, the equity must be at least 50 percent of the total investment, but not less than US\$2.1 million;
- where the total investment is between US\$10 million and US\$30 million, the equity must be at least 40 percent of the total investment, but not less than US\$5 million; and
- where the total investment is over US\$30 million, the equity must be at least 33.3 percent of the total investment, but not less than US\$12 million.

Royalty payments are not deductible if they are paid to the taxpayer's head office.⁶⁶ This prohibition is presumably intended to prevent foreign companies from shifting income outside China in the form of royalty payments. Payments to the head office for overhead and administrative expenses are deductible, provided that these payments are properly documented and approved by the local tax authorities.⁶⁷ It is difficult for the Chinese tax authorities to monitor these fees; in many cases, foreign enterprises could substitute administrative fees for royalty payments as a means of reducing taxable income in China.⁶⁸

Entertainment expenses are deductible, provided that sufficient documentary evidence is maintained and the expenses are related to the production and business operations of the taxpayer. The amount of the deduction depends on the type of business. For example, taxpayers engaged in manufacturing, construction, and farming may deduct 0.5 percent of annual sales up to RMB 15 million; where the sales exceed RMB 15 million, the deduction is limited to 0.3 percent. Taxpayers carrying on services and transportation businesses may deduct 1 percent of business revenue up to RMB 5 million; where the business revenue exceeds RMB 5 million, the deduction is limited to 0.5 percent.⁶⁹

Wages and welfare benefits paid to employees are deductible; payments to foreign social insurance plans on behalf of employees working

⁶⁶ FIT regulations, article 19(9). Similarly, royalty payments are not deductible in computing the income of a permanent establishment under the Canada-China treaty, article 7(3).

⁶⁷ FIT regulations, article 20. A FIE may apportion to its branches the management fees relating to the business of such branches: FIT regulations, article 58.

⁶⁸ FIT regulations, article 20. Payments are deductible if they are reasonably related to the business of the establishment of the foreign enterprise and supported by a document issued by the enterprise's head office specifying the management services, total amount, and basis for allocation to the Chinese establishment. These documents must be verified by a Chinese chartered accountant.

⁶⁹ FIT regulations, article 22; and Ministry of Finance Notice, *Cai Shui Zi* no. 331, December 31, 1986. It should be noted that although part of this notice has been cancelled by the STB, provisions dealing with deductions of entertainment expenses remain valid.

in China are not deductible.⁷⁰ Taxpayers engaged in financing, leasing, or providing trade credit may claim a reserve for doubtful debts for an amount up to 3 percent of the debts outstanding at the end of the year.⁷¹ When a debt becomes bad in a taxation year,⁷² the taxpayer may deduct the amount of the bad debt to the extent that it exceeds the previous year's reserve.

The cost of acquiring capital assets may be depreciated or amortized according to detailed statutory rules.⁷³ Capital assets include both fixed assets and intangible assets. Fixed assets include all tangible capital assets. Assets that are worth less than RMB2,000 and have a useful life of less than two years are deemed not be capital assets. Depreciation is based on the "original cost"⁷⁴ of the assets less residual value⁷⁵ and is computed according to the straightline method over the prescribed useful life of the assets.⁷⁶ Depreciation may be claimed once the assets are put into use. Useful life is prescribed as follows:⁷⁷

- 20 years for buildings and structures;⁷⁸
- 10 years for trains, vessels, machines, and other production equipment;

⁷⁰ FIT regulations, article 24.

⁷¹ FIT regulations, articles 25 to 27; and State Tax Bureau Reply to the Question on Deduction of Bad Debt Reserves for Late Payment of Rentals by Foreign Investment Enterprises in the Leasing Business, *Guo Shui Han Fa* no. 1531, November 3, 1992.

⁷² A debt is considered bad when (1) the debtor is bankrupt, and the debt cannot be collected after liquidation of the debtor's property; (2) the debtor has died, and the debt cannot be collected from the debtor's estate; or (3) the debt has not been paid more than two years after it became due: FIT regulations, article 26.

⁷³ FIT regulations, part III; Regulations of the People's Republic of China on Financial Administration of Foreign Investment Enterprises, passed by the Ministry of Finance on June 24, 1992; and Accounting System for Foreign Investment Enterprises in the People's Republic of China, passed by the Ministry of Finance on July 24, 1992.

⁷⁴ FIT regulations, articles 31 and 46. The original cost is determined as follows: (1) for purchased assets, the purchase price plus freight, insurance, installation expenses, and other related expenses incurred before the assets are put into use; (2) for fixed assets manufactured by the taxpayer, the cost of production; (3) for assets contributed as investment in a FIE, the reasonable value of the assets plus relevant expenses incurred before the assets are put into use; and (4) for fixed assets acquired as a gift, the reasonable appraised price.

⁷⁵ Residual value must not be more than 10 percent of original cost. If a taxpayer wishes to have a lower or no residual value, approval from the local tax authorities must be obtained. See FIT regulations, article 33.

⁷⁶ FIT regulations, articles 33 and 34. A taxpayer may use a different method of depreciation subject to the approval of the local tax authorities.

⁷⁷ If used assets are acquired and the remainder of the useful life of the assets is shorter than the prescribed period of depreciation, the depreciation period is deemed to be the remainder of the useful life of the asset. If an asset remains useful after it has been fully depreciated, no further depreciation may be claimed. FIT regulations, articles 41 and 42.

⁷⁸ These include facilities attached to the building or structure for use in production and business operations or for the provision of living quarters or welfare services for staff and workers: FIT regulations, articles 35 and 37.

- 5 years for electronic equipment, transportation equipment other than trains and vessels, appliances, tools, and furniture; and

- 6 years for assets used in the exploration of petroleum and natural gas.

The tax authorities may approve accelerated depreciation in certain cases.⁷⁹

The cost of acquiring intangible assets may be amortized.⁸⁰ “Intangible assets” include knowhow, patents, trademarks, and the right to use a site. Goodwill is not mentioned. The amortization period is prescribed as follows:

- 5 years for startup costs,⁸¹
- 1 year for offshore oil and gas development and exploration expenses,⁸²
- the remainder of the useful life as provided under contract,⁸³ and
- 10 years in other cases.

Deemed Profit

If a taxpayer is unable to submit complete and accurate evidence of its costs and expenses, its taxable income may be assessed according to a deemed profit rate.⁸⁴ For example, the deemed profit rate for taxpayers engaged in international transportation is 5 percent of gross revenue.⁸⁵

Losses

Taxpayers may deduct current losses in computing net income. Losses incurred in a taxation year may be carried forward for five years, but not

⁷⁹ FIT regulations, article 40. Assets that may qualify are machinery and equipment exposed to highly corrosive materials, buildings in a state of vibration throughout the year, machinery and equipment in operation 24 hours a day throughout the year, and assets of a joint venture whose term of operation is shorter than the prescribed useful life of the assets. Also, where the Chinese party to a cooperative joint venture takes title to the assets upon the termination of the joint venture contract, the useful life may be shorter.

⁸⁰ The acquisition cost is deemed to be the reasonable purchase price. The cost of self-developed intangibles is deemed to be expenditure on research and development. The cost of assets contributed as an investment in a FIE is deemed to be the reasonable price set out in the investment contract. FIT regulations, article 46.

⁸¹ Startup costs incurred from the date on which approval is granted for preparation of the enterprise, such as incorporation costs, expenses connected with conducting feasibility studies, and legal fees, may be amortized for 5 years after the commencement of production and business operations: FIT regulations, article 49.

⁸² Expenditures incurred in the production of petroleum may be amortized only against revenues derived from oil fields that are currently in commercial operation: FIT regulations, article 48.

⁸³ For example, where intangible assets are contributed as equity investment to a FIE or are otherwise obtained by the taxpayer and the useful life is set forth in the relevant contract, the amortization period is the prescribed useful life under the contract: FIT regulations, article 47.

⁸⁴ This may be determined by reference to the profit rate of other enterprises in the same industry or similar industries: FIT regulations, article 16.

⁸⁵ FIT regulations, article 17.

back. No distinction is made between capital losses and ordinary business losses, since capital gains are taxed as ordinary income. The FIT law provides no special rules for the treatment of losses when enterprises are reorganized or when there is a change in control.

Foreign Tax Credit and Deduction

FIEs, in computing their tax payable, may claim a credit for foreign income taxes paid on foreign source income. The credit is limited to the amount of Chinese tax otherwise payable on the foreign source income.⁸⁶ Any unused foreign tax credit may be carried forward for five years.

A foreign enterprise carrying on business in China through an establishment is taxable on its Chinese source income. Where foreign source investment income is deemed to be earned by the establishment and is taxable as profits of the establishment, the foreign enterprise may deduct the foreign income taxes paid on such income in computing taxable income.

Rates

FIEs or foreign enterprises with establishments in China pay tax at a combined rate of 33 percent, of which 30 percent is national tax and 3 percent local tax. Local tax is currently waived by many local governments under local tax incentive regulations.

Tax Incentives

Various tax incentives are available to FIEs. They include tax holidays and tax reductions for special areas and special industries. Eligibility for a particular incentive is generally determined by local tax authorities, on the basis of the taxpayer's application.

Tax Holidays

FIEs that are engaged in productive activities with an operating period of 10 years or more are eligible for a 5-year tax holiday, which includes a tax exemption for the first 2 profit-making years and a half-rate reduction for the next 3 years.⁸⁷ FIEs operating in farming, forestry, or animal

⁸⁶ Income from a foreign country is computed in accordance with Chinese laws; costs, expenses, and losses may be deducted if they are attributable to the foreign source income. Foreign source income and foreign income taxes paid are computed on a per-country rather than a per-item basis. There is no requirement that the foreign tax be a direct tax. Underlying corporate taxes paid in a foreign country also may be eligible for the credit. See FIT regulations, articles 83 to 86.

⁸⁷ FIT law, article 8. "Operating period" is defined as starting from the day an enterprise "actually" goes into production and operation, including trial production; FIT regulations, article 74. Thus, a 10-year venture whose feasibility study calls for a 1-year construction period before production starts will not enjoy a tax holiday. The end of the operating period is the time when operations actually cease. As a result, an enterprise that shuts down production after 9 years but continues to exist for another year apparently will have to give back its forgiven taxes. FIT regulations, articles 74 and 79.

husbandry or in remote, economically underdeveloped areas may receive a further reduction of 15 percent to 30 percent for another 10 years following the end of the 5-year period. "Productive activities" are broadly defined to include manufacturing, processing, construction, and agricultural projects.⁸⁸ Real estate development and services are not considered "productive activities."

A 10-year tax holiday (5-year tax exemption and 5-year half-rate reduction) applies to the following enterprises with a scheduled operating term of 15 years or more:

- equity joint ventures engaged in port and pier construction projects,
- FIEs engaged in infrastructure projects or in agricultural development in the Hainan special economic zone,⁸⁹ or
- FIEs in the Shanghai Pudong new area engaged in construction projects in energy and transportation.⁹⁰

A 3-year tax holiday (including a 1-year tax exemption and a 2-year half-rate reduction) is available to

- branches of foreign banks and joint venture banks established in the SEZs and other authorized areas with foreign capital of more than US\$10 million,

⁸⁸ Other productive activities include activities in the following areas:

- energy (excluding the exploitation of petroleum and natural gas);
- metallurgical, chemical, and building materials, light industries, textiles, and packaging;
- medical apparatus and pharmaceutical industries;
- agriculture, forestry, animal husbandry, fisheries, and water conservation;
- construction;
- communications and transportation (other than passenger transport);
- scientific and technological development;
- geological surveying and industrial information consultancy that directly serve the purposes of production; and
- maintenance services for production equipment and precision instruments.

See FIT regulations, article 72; and State Tax Bureau Notice on the Explanation and Determination of Productive Activities of Foreign Investment Enterprises in Other Industries, *Guo Shui Fa* no. 109, April 29, 1992.

⁸⁹ The special economic zones are Shenzhen, Zhuhai, Shantou, Xiamen, and Hainan Province.

⁹⁰ FIT regulations, articles 75(1) to (3). See Provisional Regulations on Reduction and Exemption of Enterprise Income Tax and the Consolidated Industrial and Commercial Tax for the Special Economic Zones and the 14 Coastal Cities, promulgated by the State Council on November 15, 1984 (herein referred to as "the SEZs tax regulations"); Regulations Concerning the Encouragement of Investment and Development of Hainan Island, issued by the State Council on May 4, 1988 (herein referred to as "the Hainan regulations"); and Regulations Concerning the Reduction and Exemption of Enterprise Income Tax and Consolidated Industrial and Commercial Tax in the Pudong New Zone in Order To Encourage Foreign Investment, approved by the State Council on September 7, 1990 and issued by the Ministry of Finance on September 11, 1990 (herein referred to as "the Pudong regulations").

- equity joint ventures in the state high- and new-technology industry development zones, and
- FIEs in the SEZs with foreign investment in the service industry of more than US\$5million.

The term of a tax holiday commences with a taxpayer's "first profit-making year," which is the year in which a taxpayer begins to make a profit after taking into account any loss carryovers. The duration of the tax holiday is calculated without any interruption.⁹¹ To qualify for a tax holiday, a taxpayer must actually carry on business during the specified operating period of 10 or 15 years. If a taxpayer terminates the operation before the end of the minimum period, the amount of the forgone tax must be repaid.

Lower Rates in Special Areas

The national rate of 30 percent is reduced to 15 percent or 24 percent for FIEs operating in certain special areas. The 24 percent rate applies to FIEs carrying on productive activities in the open coastal economic zones (OCEZs)⁹² and in the "old city area" of cities where the SEZs and the economic and technological development zones (ETDZs)⁹³ are located. The 15 percent rate applies to⁹⁴

- FIEs and establishments of foreign enterprises that carry on productive activities in the SEZs and ETDZs;
- FIEs that operate in projects that are technology intensive or knowledge intensive, that have a long-term foreign investment of US\$30 million or more, or that are in energy, transportation, or port construction in the OCEZs or the "old city area" of cities where the SEZs or ETDZs are located;⁹⁵

⁹¹ Where a taxpayer commences actual production operations in the second half of a taxation year and becomes profitable in the same year, the enterprise may elect to pay income tax on the profits earned during that year and to begin using the tax holiday during the subsequent year: FIT regulations, articles 76 and 77.

⁹² FIT regulations, article 70; and Interim Provisions of the State Council on Reduction and Exemption of Enterprise Income Tax and Consolidated Industrial and Commercial Tax for Open Coastal Economic Zones, issued on June 15, 1988 (herein referred to as "the OCEZ regulations"). Cities in the Liaodong Peninsula, Shandong Peninsula, Changjian Triangle, Zhoujiang Triangle, and Minnan Triangle were designated as OCEZs.

⁹³ In 1984, ETDZs were established in the 14 coastal cities of Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhanjiang, and Beihai: see SEZ tax regulations. Subsequently, more cities have been designated as ETDZs, including Wenzhou, Kunshan, Weihai, Yingkou, Rongqiao (Fuqing), Dongshan, Shenyang, Harbin, Changchun, Hangzhou, Wuhu, Wuhan, Chongqing, Dayawan (Huizhou), Fanyu-Nansha (Guangzhou), and Xiaoshan. See *People's Daily* (overseas edition), July 2, 1993.

⁹⁴ FIT law, article 7; and FIT regulations, article 73.

⁹⁵ FIT regulations, article 73(1). See also SEZ tax regulations, part III, article 1; and OCEZ regulations, article 1. The FIT regulations do not define some key concepts, such as "technology intensive or knowledge intensive," and "long payback period."

- branches of foreign banks and joint venture banks with a minimum capital investment of US\$10 million and a scheduled operating term of at least 10 years;
- FIEs in the Shanghai Pudong new area engaged in production or construction projects in the areas of energy, transportation, and communications;
- FIEs operating in the state high- and new-technology industry development zones;⁹⁶ and
- others as designated by the State Council.⁹⁷

The 15 percent rate also applies to equity joint ventures engaged in port and pier construction projects in any part of the country.

As this array of tax incentives suggests, China has begun to resemble one big special economic zone. Foreigners contemplating investment in China should, however, be wary of special arrangements offered by local authorities that appear to extend beyond the general contours of the FIT law. Although provincial governments have authority to grant exemptions from the local surtax, other exemptions must not deviate from the FIT law without special approval from the central government.

Export-Oriented Enterprises and Technologically Advanced Enterprises

Export-oriented enterprises and technologically advanced enterprises are entitled to additional tax concessions. "Export-oriented enterprises" are FIEs that export more than 70 percent of their products as assessed annually by the local tax authorities.⁹⁸ "Technologically advanced enterprises" are FIEs that possess advanced technology and are engaged in developing new products or upgrading products to earn foreign exchange from exports

⁹⁶ State Tax Bureau Notice on Matters Relevant to Foreign Income Tax with Respect to Implementing the State Council Policy Concerning Taxation of State New and High-Technology Development Zones, *Guo Shui Han Fa* no. 663, September 16, 1991.

⁹⁷ State Tax Bureau Notice Concerning Foreign Tax Policy Regarding Further Opening of Border, Coastal and Provincial Capital Cities to Foreign Investment, *Guo Shui Fa* no. 218, September 18, 1992. In this notice, the STB designated more cities to be "open cities" for purposes of the FIT law and regulations. These cities include Changchun, Changsha, Chengdu, Chongqing, Guiyang, Harbin, Hefei, Huhhot, Jiujiang, Kunming, Lanzhou, Nanchang, Nanning, Shijiazhuang, Taiyuan, Urumqi, Wuhan, Wuhu, Xian, Xining, Yinchuan, Yueyang, and Zhengzhou. The effect of such designation is that FIEs in these cities engaged in production will be taxed at the reduced rate of 24 percent rather than the normal rate of 30 percent. FIEs are taxed at the reduced rate of 15 percent if they are engaged in projects involving high technology, energy, transportation, or port construction, or if the investment in the enterprise by the foreign investor is more than US\$30 million with a long term for recovery of investment.

⁹⁸ Provisions of the State Council of the People's Republic of China for the Encouragement of Foreign Investment, adopted October 11, 1986; Measures of the Ministry of Finance for the Implementation of Preferential Tax Terms, adopted on January 30, 1987, article 5; and Implementing Measures of the Ministry of Foreign Economic Relations and Trade on the Confirmation and Examination of Export-Oriented Enterprises and Technologically Advanced Enterprises with Foreign Investment, issued on January 27, 1987, article 5.

or from import substitution.⁹⁹ FIEs do not automatically qualify as “technologically advanced” or “export oriented” simply because they use advanced technology in production or because they export most of their products; they must apply to the local tax authorities for the special status.

By obtaining export-oriented or technologically advanced status, FIEs receive a 50 percent reduction in the national tax rate after the regular tax holidays. For FIEs that are already taxed at 15 percent, the reduced rate is limited to 10 percent. The rate reduction is applicable for three additional years for technologically advanced FIEs; it is available indefinitely for export-oriented FIEs provided that they maintain export-oriented status.

Tax Refund for Reinvestment

A foreign investor in a FIE may receive a refund of 40 percent of the tax paid by the FIE on the investor’s share of income that is reinvested in China. A full refund is available if the profit is reinvested in an export-oriented or technologically advanced enterprise,¹⁰⁰ or in a FIE engaged in the infrastructure or agricultural development projects in the Hainan SEZ.¹⁰¹ To obtain the refund, the foreign investor must apply to the local tax authorities and invest the funds in the same FIE or another FIE for at least five years. If the foreign investor withdraws any of the reinvested profits within five years, the refund must be repaid.¹⁰²

Non-Resident Withholding Tax

Withholding tax applies to dividends, interest, rents, fees for the use of proprietary rights, and capital gains derived from China by non-residents.¹⁰³ The withholding tax rate is 20 percent of the gross payment, subject to reductions and exemptions under the FIT law and tax treaties.¹⁰⁴ An amount

⁹⁹ The criteria for “technologically advanced” enterprises are not specified in the FIT regulations and may be subject to standards set out by the State Science and Technology Commission. See State Tax Bureau Notice no. 663, *supra* footnote 96, article 4.

¹⁰⁰ If the FIE receiving the reinvested profits fails to meet the requirements for an export-oriented or technologically advanced enterprise within three years, 60 percent of the tax refund obtained must be paid back—that is, only the regular 40 percent tax refund is applicable: FIT regulations, article 81.

¹⁰¹ The profit must be derived from FIEs in the Hainan SEZ: FIT regulations, article 81; and Hainan regulations, article 19.

¹⁰² FIT regulations, article 80. Foreign investors must provide evidence confirming the taxation year to which the reinvested profits are attributable when calculating a tax refund. If the foreign investor is unable to provide such evidence, the tax authorities may determine the relevant tax year. The foreign investor must also provide evidence of either the capital increase or the new capital contribution to another enterprise.

¹⁰³ FIT law, article 19; and FIT regulations, part V. Withholding tax is levied when a payment of the Chinese source income is made to a foreign enterprise. “Payments” include payments in cash, payments by remittance, payments by account transfer, and payments made by conversion into money of non-monetary assets or non-financial rights and benefits.

¹⁰⁴ Withholding tax is reduced under the treaty to 10 or 15 percent: Canada-China treaty, articles 10 to 12.

that is deemed to be earned through the establishment of a foreign enterprise in China is taxable on a net basis as business profits under the above-described rules and rates.¹⁰⁵

*Dividends*¹⁰⁶

Dividends are considered to be from Chinese sources if they are paid by enterprises (FIEs and other enterprises) in China.¹⁰⁷ Dividends paid by FIEs are currently exempt from withholding tax. Dividends paid by other enterprises may be subject to Chinese withholding tax.¹⁰⁸

Interest

For withholding tax purposes, interest on deposits, loans, bonds, advances, and deferred payments is considered to be derived from a Chinese source if it is paid by a person resident in China. There may be an exemption for interest on loans extended to the Chinese government or China's state banks by international financial organizations,¹⁰⁹ or for interest on loans given at a preferential rate¹¹⁰ by foreign banks to China's state banks.¹¹¹ Interest payable on a loan directly or indirectly guaranteed by the Canadian Export Development Corporation is exempt from Chinese withholding tax.¹¹² The tax rate is reduced to 10 percent on interest for loan contracts signed between 1983 and 1995.¹¹³

¹⁰⁵ See supra footnote 56 and the accompanying text.

¹⁰⁶ The FIT legislation uses the word "profits" (*lirun*) rather than "dividends." "Profits received from another enterprise" refers to "income derived by virtue of an investment ratio, share rights, stock or other non-creditor's right to a share of profit." See FIT law, article 19; and FIT regulations, article 60.

¹⁰⁷ FIT regulations, article 63.

¹⁰⁸ See supra footnote 38 and the accompanying text.

¹⁰⁹ "International financial organizations" include "international financial organizations such as the International Monetary Fund, the World Bank, the Asian Development Bank, the International Development Association, and the International Fund for Agricultural Development": FIT regulations, article 64.

¹¹⁰ The term "preferential rate" is not defined in the FIT regulations. The previous legislation defined the term to mean a rate at least 10 percent below the prevailing international financial market rate, or at the "international interbank rate for call funds," a term that includes the London interbank offering rate (LIBOR) and similar interbank rates. See Provisional Regulations of the Ministry of Finance of the People's Republic of China Regarding the Reduction and Exemption of Income Tax on Interest Earned by Foreign Businesses from China, January 7, 1983 (herein referred to as "the interest regulations").

¹¹¹ FIT law, article 19(3). "China's state banks" include the People's Bank of China, the Agricultural Bank of China, the Bank of China, the People's Construction Bank of China, the Bank of Communications, and the China Investment Bank: FIT regulations, article 65. Interest on loans to the China National Offshore Oil Corporation, the body responsible for the cooperative offshore oil exploration and development projects with foreign oil companies, also may be exempted from the withholding tax: the interest regulations.

¹¹² Canada-China treaty, article 11(3)(a)(iii).

¹¹³ This reduction is authorized by the tax administration. The interest regulations have been amended twice, in 1986 and again in 1990.

Rent

“Rent” is derived from a Chinese source if it is paid for the use of property in China. Rents for containers used in international shipping are currently exempt from withholding tax.¹¹⁴

Fees for the Use of Proprietary Rights (Royalties)

Perhaps the most significant targets of the withholding tax are “fees for the use in China of proprietary rights,”¹¹⁵ which include royalties or license fees for the use in China of patents or other proprietary technology, trademarks, and copyright. In addition, fees for technical training, technical services, and technical documentation provided by foreign companies in relation to the transfer of proprietary rights to a Chinese entity are considered within this category of income.¹¹⁶

The rate of withholding tax may be reduced to 10 percent or waived if the technology is “advanced” and offered on “preferential” terms,¹¹⁷ and the technology is related to scientific research, the development of energy resources, transportation, communications, or production in agriculture, forestry, animal husbandry, or fishing. Other fees that also may be exempt from tax are fees payable to foreign companies for services such as consultation with Chinese enterprises on management methods, assistance in performing feasibility studies, technical training, and design of construction sites and equipment; and fees paid under equipment sales contracts in respect of the installation and for technical assistance with the operation and maintenance of the equipment.¹¹⁸

Furthermore, withholding tax on interest, rents, and fees for the use of proprietary technology earned by foreign enterprises from the SEZs, ETDZs,

¹¹⁴ State Tax Bureau Notice on the Question of Exempting Tax on a Temporary Basis for Rentals for the Use of Foreign Containers in International Shipping, *Guo Shui Fa* no. 49, March 11, 1993.

¹¹⁵ The Chinese term *texuquan shiyongfei* can be translated as “royalties,” but the term “royalties” is too narrow and fails to capture the intended scope of the Chinese term. The precise Chinese word for “royalties” in the western sense of that term is *tichengfei*.

¹¹⁶ FIT regulations, article 59; State Tax Bureau Notice, *Cai Shui Wai Zi* no. 143, October 14, 1982; and Provisional Regulations of the Ministry of Finance Regarding the Reduction of and Exemption from Income Tax on Fees for the Use of Proprietary Technology, *Cai Shui Zi* no. 326, December 13, 1982 (herein referred to as “the proprietary technology provisions”).

¹¹⁷ FIT law, article 19(4); FIT regulations, article 66; and proprietary technology provisions, article 1. In determining whether technology is “advanced” for the purpose of the tax exemption, the importing Chinese entity must evaluate which of the available technologies will be most effective and transmit its findings to the tax authorities for a decision. In determining whether the technology is offered on “preferential terms,” the tax authorities will consider such factors as whether the cost is low relative to comparable technology, whether free training is included, whether payment may be made in kind rather than in cash, and whether the Chinese transferee may continue to use the technology free of charge after the termination of the contract.

¹¹⁸ Proprietary technology provisions, article 2; and Ministry of Finance Notice Concerning the Levy of Income Tax on Income Derived from Patents and Proprietary Rights, *Cai Shui Zi* no. 109, May 8, 1982.

and OCEZs may be taxed at the reduced rate of 10 percent if such income is not otherwise exempt from tax under the above rules and regulations.¹¹⁹

Capital Gains

Capital gains from the disposition of property¹²⁰ in China are subject to withholding tax at 20 percent of the net gain.¹²¹ Tax is withheld by the purchaser of the property. Under article 13 of the Canada-China treaty, capital gains derived by Canadian residents are not taxable in China unless the gains are derived from the alienation of immovable property in China, movable property forming part of the business property of a Canadian company's permanent establishment in China, or shares of a Chinese company whose property consists principally of immovable property located in China.

Transfer Pricing

In response to a growing concern over potential revenue loss, the Chinese tax authorities introduced transfer-pricing rules in 1991. Taxpayers must deal at arm's length with their affiliates.¹²² The tax authorities are authorized to adjust a taxpayer's income where business transactions between affiliates are not conducted at arm's length.¹²³

The term "affiliate" is broadly defined to mean any company, enterprise, or other economic organization that has direct or indirect control over the capital, business operations, sales, and purchases of the taxpayer; that is controlled by a third party that controls the taxpayer; or that has any affiliate relationship arising from mutual interests.¹²⁴ In practice, a company is considered an "affiliate" of a taxpayer where

- the company directly or indirectly owns 25 percent or more of the shares of the taxpayer;
- a third party directly or indirectly owns at least 25 percent of the shares of both the company and the taxpayer;

¹¹⁹ Hainan regulations, article 13; SEZ tax regulations, part I, article 1(4) and part II, article 1(4); and Pudong regulations, article 10.

¹²⁰ "Property" refers to buildings, structures, facilities ancillary to such buildings and structures, and land-use rights: FIT regulations, article 6(2).

¹²¹ Net gain is the proceeds of disposition less the original cost of the property: FIT regulations, article 61.

¹²² Taxpayers must provide the local tax authorities with relevant information on prices and expenses in respect of business transactions with their affiliates. Failure to report this information may subject the taxpayer to penalties. FIT regulations, article 53.

¹²³ FIT law, article 13. The statute of limitation for adjustment by the tax authorities is 10 years: State Tax Bureau Notice on Implementing Measures for the Administration of Transactions Between Affiliated Enterprises, *Guo Shui Fa* no. 237, October 29, 1992 (herein referred to as "the transfer-pricing notice"), article 9.

¹²⁴ FIT regulations, article 54; and transfer-pricing notice, article 2.

- the taxpayer's debt to the company accounts for 50 percent or more of the taxpayer's total capital, or 10 percent of the taxpayer's debt is guaranteed by the company;
- more than half of the directors or high-level managers of the taxpayer are appointed by the company;
- the taxpayer's business operations depend on the use of the company's proprietary technology;
- the company controls the taxpayer's supply of raw materials and spare parts and the sale of products; or
- the company controls the taxpayer's business operations in other ways—for instance, the owners or managers of the company and the taxpayer are related.

“Arm's-length transaction” refers to a business transaction between non-affiliated enterprises conducted at fair prices and according to common business practice. For instance, with respect to the sale of goods, the arm's-length price is determined by internationally accepted methods, such as the price of a comparable transaction between unaffiliated parties, the profit margin from resale to an unaffiliated party, the cost-plus method, or any other reasonable method.¹²⁵

Where a taxpayer's income is adjusted to meet the arm's-length standard, the amount of payments in excess of the arm's-length price to a foreign affiliate is deemed to be a dividend to the foreign affiliate.¹²⁶ The deemed dividend is subject to withholding tax and is ineligible for any exemptions.¹²⁷

VAT and Other Taxes

Sales of goods and services are subject to the VAT, the business tax, and the consumption tax. With respect to FIEs, these taxes replaced an earlier turnover tax—the consolidated industrial and commercial tax.¹²⁸

VAT

The Chinese VAT is similar to the VAT in other countries. VAT applies to all individuals and entities that are engaged in the sale of goods in China, the provision of repair or processing services in China,¹²⁹ or the importation of goods into China. Goods are deemed to be sold in China if they are

¹²⁵ FIT regulations, article 54.

¹²⁶ Transfer-pricing notice, article 10.

¹²⁷ Ibid.

¹²⁸ The Law of the People's Republic of China on the Consolidated Industrial and Commercial Tax (Draft), issued by the State Council on September 13, 1958. The implementing rules were issued by the Ministry of Finance on September 13, 1958.

¹²⁹ Other services are subject to the business tax (see the text below).

shipped from China or located in China.¹³⁰ Imports of capital assets by a foreign company as a capital contribution to a FIE are exempt from VAT.¹³¹

For the purposes of VAT, “goods” include all tangible movable property, including electricity, heating power, and gas. The sale of immovable or intangible property is not taxable under the VAT. It is not clear whether “goods” include the sale of a business.

VAT is imposed on the consideration received for the sale of goods or provision of services. The taxable value for imports is the customs value plus customs duty, consumption tax, and insurance and freight costs incurred in bringing the goods to China. VAT is payable when goods are imported or sold and when services are rendered.¹³²

In computing VAT liability, taxpayers may claim a refundable input tax credit for VAT paid on the purchases of business inputs.¹³³ The amount of the input credit on agricultural products that are exempt from the tax is deemed to be 10 percent of the purchase price. The amount of VAT paid on business inputs must be supported by invoices.¹³⁴

Unlike the Canadian goods and services tax (GST), the VAT law allows no credit for VAT paid on the purchase of fixed assets. Like the GST, the VAT denies an input credit for goods that are not directly used in supplying taxable goods or services, such as goods purchased for producing exempt goods or for personal consumption.

¹³⁰ There is a deemed sale of goods where a taxpayer transfers goods to another person for sale on a consignment basis; where goods are transferred from the taxpayer to its branch located outside the country jurisdiction for sale by the branch; where taxable goods are used by the taxpayer to manufacture non-taxable goods; where goods are used as capital investment; where taxable goods are used for welfare or personal consumption; or where taxable goods are given to other persons: VAT regulations, article 4.

¹³¹ See “The New Tax System Is Beneficial to Foreign Investment in China,” *People’s Daily* (overseas edition), May 10, 1994. Certain other supplies are exempt from VAT, none of which are relevant to foreign companies doing business in China. Goods exempt from tax include agricultural products produced and sold directly by farmers, contraceptive medicines, antique books, used goods, imported instruments and equipment for scientific research, and educational goods or equipment given to the taxpayer by foreign governments or international organizations; other exemptions also may be permitted by the State Council. See VAT law, article 16.

¹³² This is deemed to be the earliest of the time when payment is received by the seller, goods are delivered, the sale agreement is signed, and an invoice is issued.

¹³³ Taxpayers pay VAT on the value added by them. Small suppliers are taxed under a simpler method; they are allowed to compute their tax liability on the basis of their turnover at the rate of 6 percent. They are not entitled to claim any input tax credit, but small suppliers with an established accounting system may elect to be taxed on the value-added basis and claim the credit. VAT law, article 2.

¹³⁴ Where a taxpayer is engaged in the production of both taxable supplies and exempt supplies, the taxpayer must apportion its purchases for input tax credit purposes: VAT regulations, article 23.

The standard rate is 17 percent; a reduced rate of 13 percent applies to necessities and other specified items.¹³⁵ Exports are zero-rated in order to allow exporters to claim a full refund for VAT paid on business inputs.

Taxpayers must register for VAT purposes with the local tax office before the commencement of business activity.¹³⁶ Specially designed VAT invoices must be used. Taxpayers must maintain an account of VAT charged on sales and VAT paid on inputs as well as a “net” account showing the status of remittances to, or refunds from, the tax authorities.¹³⁷

Foreign companies that render taxable services in China without establishments in China are liable to the VAT. The amount of tax payable by such companies must be withheld by the company’s customers or agents.¹³⁸

Business Tax

Business tax is levied on revenues from the following activities:

- the transfer¹³⁹ of intangible property in China (including land-use rights, patents, knowhow, trademarks, copyright, and goodwill);
- the sale of immovable property in China;¹⁴⁰ and
- transportation, communications, construction, banking, finance, insurance, postal communication, telecommunications, cultural activities, sports, entertainment, and service businesses.

Unlike the VAT, the business tax does not provide any credit for taxes paid on business inputs. Taxpayers generally pay tax on their gross business turnover; some taxpayers may deduct certain expenses, such as fees paid to subcontractors, in computing their tax liability. For example, banks

¹³⁵ These include grain and edible oil, running water, hot water, gas, residential coal products, air conditioning and central heating, books, newspapers, magazines, feed, chemical fertilizers, pesticides, farm machinery, agricultural plastic film, and other goods as stipulated by the State Council.

¹³⁶ Law of the People’s Republic of China Concerning the Administration of Tax Collection, promulgated by the 27th Session of the 7th National People’s Congress on September 4, 1992, articles 9 to 11. For a discussion of the Chinese tax administration, see Jinyan Li, “People’s Republic of China: The New Law on Tax Administration” (May 1993), 47 *Bulletin for International Fiscal Documentation* 263-77.

¹³⁷ VAT may be paid on the basis of 1 day, 3 days, 5 days, 10 days, 15 days, or 1 month; the applicable payment period is determined by local tax authorities. Taxpayers with large amounts of VAT payable are required to pay tax more frequently than others. Returns must generally be filed within the first 10 days of the following month. Regulations on Value-Added Tax Accounting, issued by the Ministry of Finance on December 27, 1993.

¹³⁸ VAT regulations, article 34.

¹³⁹ Transfer of intangible property includes sales, leasing, rental, and licensing transactions.

¹⁴⁰ “Immovable property” includes buildings and other structures affixed to the land. A “sale of immovable property” includes any transfer of limited immovable property rights or permanent rights to use immovable property, including the donation of such property by a taxpayer. Business tax regulations, article 4.

and other financial institutions may deduct interest payments on borrowed funds.¹⁴¹

The tax rates are as follows: 3 percent for transportation, construction, postal communication, and engineering services provided in China;¹⁴² 5 percent for banking and insurance services provided in China, the transfer of intangible property, and the sale of immovable property; and 5 percent to 20 percent for entertainment (the applicable rate is determined by local governments).¹⁴³ Joint venture banks and branches of foreign banks are exempt from the business tax for the first five years of operation.¹⁴⁴

Business tax is generally withheld by payers. For example, tax is withheld from fees payable to foreign companies carrying on taxable activities in China without establishments in China. Similarly, general contractors must withhold tax from payments to subcontractors, and general insurers must withhold tax from payments to sub-insurers.¹⁴⁵

Consumption Tax

The consumption tax is an excise tax. It applies to the manufacturing and importing of certain luxury goods and is levied in addition to VAT.¹⁴⁶ Taxable goods include tobacco, liquor, cosmetics, fireworks and firecrackers, gasoline, diesel fuel, tires, motorcycles, and automobiles. Export goods and goods manufactured by taxpayers for the production of other taxable goods are exempt from the tax.

Tax rates range from 3 percent on small cars to 45 percent on top-quality cigarettes. Gasoline and diesel fuel are taxed on an ad valorem basis at RMB0.2 per litre and RMB0.1 per litre, respectively.

¹⁴¹ Business tax law, article 5; and business tax regulations, article 3. Financial institutions engaged in the trading of currencies, securities, and futures contracts are taxable only on the difference between the sales proceeds and the cost of purchase. Individuals and non-financial institutions engaged in such businesses are not taxable.

¹⁴² Business tax regulations, articles 7 and 8. A business activity is carried on in China where services are provided within China; passengers or goods are transported within China and from China to other countries; tourist services are arranged from within China for tours in and outside China; the transferred intangible property is used within China; the transferred immovable property is located within China; insurance services are provided by companies within China, with the exception of insurance in respect of export goods; or insurance services are provided by insurance companies outside China for assets located within China.

¹⁴³ Business tax law, article 2.

¹⁴⁴ This exemption was recently announced by an official of the STA; see *People's Daily* (overseas edition), May 10, 1994.

¹⁴⁵ Business tax regulations, article 29.

¹⁴⁶ The consumption tax is levied to recover the loss of revenue caused by the reduction in tax rates under the VAT. Goods taxable under this tax are goods that were previously subject to tax at rates higher than the 17 percent VAT rate. For example, top-grade cigarettes were previously taxed at 69 percent, and cosmetics were taxed at 40 percent.

Other Taxes

Other important taxes with an impact on foreign business and investment include the resource tax, the real estate gains tax, the real estate tax, the deed tax, the vehicle and vessel licence tax, and the stamp tax.

Resource Tax

The resource tax applies to taxpayers that are engaged in mining or producing crude oil, natural gas, coal, non-ferrous metals, ferrous metals, and salt in China.¹⁴⁷ Tax is levied on an ad valorem basis on sales of the taxable products.¹⁴⁸ The amount of tax payable is determined by the Ministry of Finance according to the mining or production conditions of the taxpayer.¹⁴⁹

Real Estate Gains Tax

The real estate gains tax was introduced in 1993 in an attempt to regulate the growing real estate market in China.¹⁵⁰ It applies to gains¹⁵¹ from the transfer of land-use rights, buildings, and other structures affixed to land.¹⁵²

¹⁴⁷ Provisional Regulations of the People's Republic of China on Resource Tax, promulgated by the State Council on December 25, 1993; Detailed Rules for the Implementation of the Resource Tax were issued by the Ministry of Finance on December 30, 1993.

¹⁴⁸ The following table indicates taxable items and amounts under the resource tax:

<i>Taxable items</i>	<i>Tax payable</i>
Crude oil	RMB 8-30 per tonne
Natural gas	RMB 2-15 per 1,000 cubic metres
Coal	RMB 0.3-5 per tonne
Other non-metal minerals	RMB 0.5-20 per tonne
Ferrous metals	RMB 2-30 per tonne
Non-ferrous metals	RMB 0.4-30 per tonne
Salt:	
Solid salt	RMB 10-60 per tonne
Liquid salt	RMB 2-10 per tonne

¹⁴⁹ Tax may be reduced or exempted where crude oil is used for heating and repairing wells in the course of production or where a taxpayer suffers serious financial losses owing to accident or natural disaster. In addition, the State Council may reduce tax or grant an exemption from tax in other circumstances.

¹⁵⁰ Provisional Regulations of the People's Republic of China on Real Estate Gains Tax, adopted by the State Council on November 26, 1993 and promulgated on December 13, 1993. Implementing regulations for this tax have not yet been introduced.

¹⁵¹ The amount of the gain is calculated as the proceeds of transfer less the cost of acquiring the property, development expenses, repair and maintenance expenses, relevant tax payments, and other amounts that are approved as deductible by the Ministry of Finance. The proceeds of transfer include payments in cash and in property. Tax may be assessed on the basis of an estimated value of the property if the taxpayer has committed fraud or sold a property at a price below the reasonable price.

¹⁵² Unlike the legislation for the VAT, the consumption tax, and the business tax, this tax law does not clearly state whether or not it applies to FIEs and foreign enterprises. It is reasonable to assume that these enterprises are subject to the tax since the law does not specifically exempt them. Indeed, foreign and Hong Kong real estate developers are likely to be major payers of this tax.

Tax is levied at progressive rates ranging from 30 percent to 60 percent.¹⁵³ Gains from the sale of standard dwelling places are exempt from tax to the extent that the gain is less than 20 percent of the cost and related expenses. Similarly, no tax is imposed on gains from property appropriated by the government.

Urban Real Estate Tax

The urban real estate tax¹⁵⁴ is a local tax payable by persons who own real estate in China. The tax rate is 1.2 percent of the value of the real estate, or 18 percent or 12 percent of the rental income where the property is rented. The value of the property is normally 70 to 90 percent of the original cost of the property, the exact amount of which is determined by the local government.¹⁵⁵

Deed Tax

The deed tax¹⁵⁶ applies to deeds or contracts in respect of the purchase and sale, mortgage, bequest, or exchange of real property in China. For example, where a FIE, foreign enterprise, or individual acquires ownership of a house, tax is imposed at 6 percent of the value of the house.

Vehicle and Vessel Licence Tax

The vehicle and vessel licence tax is payable by the owners of vehicles or vessels in China.¹⁵⁷ In order to obtain a licence plate for a vehicle or vessel, the taxpayer must apply to the local tax office to register it and pay the tax.

Stamp Tax

The stamp tax¹⁵⁸ applies on the signing or issuance of commercial contracts and documents. Tax rates vary according to the nature of the

¹⁵³ The tax is imposed at progressive marginal rates based on four brackets, as indicated below:

<i>Gains in excess of cost basis</i>	<i>Tax rate (%)</i>
Less than 50%	30
Portion between 50% and 100%	40
Portion between 100% and 200%	50
Portion over 200%	60

¹⁵⁴ Provisional Regulations of the People's Republic of China on Urban Real Estate Tax, promulgated on August 8, 1951 by the Government Administration Council.

¹⁵⁵ Local governments issue implementing rules for this tax: for example, Implementing Rules for the Real Estate Tax in the Shenzhen Special Economic Zone, passed by the Shenzhen Municipal People's Government on May 4, 1987.

¹⁵⁶ Provisional Regulations on Deed Tax, promulgated by the Administrative Council on April 3, 1950.

¹⁵⁷ Provisional Regulations Governing the Vehicle and Vessel Licence Tax, promulgated on September 13, 1951 by the Government Administration Council of the Central People's Government.

¹⁵⁸ Provisional Regulations of the People's Republic of China on Stamp Tax, adopted by the State Council on June 24, 1988, and the implementing regulations for this tax issued by the Ministry of Finance on September 29, 1988.

document. For example, loan contracts are taxed at 0.005 percent of the loan amount; property insurance contracts are taxed at 0.003 percent of the amount insured; technology contracts are taxed at 0.03 percent of the contractual price; business accounting documents are taxed at 0.05 percent of the recorded capital; and property transfer documents are taxed at 0.05 percent of the transfer price.¹⁵⁹ Taxpayers pay the tax by purchasing and affixing tax stamps. Stamp tax does not apply to duplicate copies of documents for which the tax has already been paid.¹⁶⁰

ALTERNATIVE STRUCTURES AND THEIR TAX IMPLICATIONS

This section of the article identifies some common structures used by foreign companies doing business in China and explores the tax consequences associated with each, particularly for Canadian companies. A variety of approaches are available, similar to those that exist in other countries. At one end of the spectrum, a Canadian company can simply export its goods or technology to China, either through an outright sale or through a licensing or leasing arrangement. In conjunction with the sale or arrangement, some technical training or ancillary support services might be provided to the Chinese customer. At the other end of the spectrum, a company seeking more substantial involvement can set up a representative office or branch, form a contractual or equity joint venture, or even establish a wholly owned subsidiary. Recently, it has also become possible for Canadian investors to invest in Chinese enterprises through stock exchanges in China, Hong Kong, the United States, and Canada.

The choice of doing business in a particular form may be influenced by numerous factors. These factors may include internal company policy with respect to doing business abroad and the degree of commitment and involvement the company seeks with China; the Chinese government's policy toward a particular type of investment vehicle; the nature of the business activity in China; and the need for local participation. In addition, China's expanding system of laws and regulations governing foreign businesses, including tax laws and regulations, must be considered.

As China's tax structure for foreign businesses becomes more complex, the tax ramifications of various ways of doing business in different parts of China become more significant. Different investment vehicles may attract very different tax consequences, depending on the location, duration, and nature of the investment. Canadian companies should also consider the terms of the Canada-China treaty in structuring their activities.

¹⁵⁹ Share certificates may be subject to the tax at the rate of 3 percent. See Interim Regulations of the Shenzhen Municipal Government on the Taxation of Transfer of Shares and Gains of Individuals from Holding Shares, *Shenzhen Tax Handbook* (1993), 409-10.

¹⁶⁰ Taxpayers may apply for a tax reduction if they have difficulty paying the tax for loan contracts, technology contracts, purchase and sale contracts, and leasing contracts.

The Canada-China treaty, like most of China's tax treaties, follows the OECD model treaty. It also contains a general tax-sparing clause,¹⁶¹ under which a Canadian resident may claim a credit against Canadian income tax liability for taxes that are payable in China but are spared under Chinese law. For example, where a Canadian company receives interest from China that is exempt from Chinese withholding tax, the Canadian company is deemed to have paid tax at the rate of 10 percent for the purposes of computing any foreign tax credit.¹⁶²

Trading with China

Export of Goods and Services

The intermittent sale of goods and services by a Canadian company to China does not attract any Chinese income tax. If, however, the company also provides installation, training, or other services at the end-user's site over a period of time, the company may be creating a "permanent establishment" in China within the meaning of the treaty, and its service income will be taxable in China. If the company's activities are not sufficient to create a "permanent establishment," the service income may be treated as "management fees" or "fees for the use of proprietary technology" and be subject to withholding tax under the FIT law.¹⁶³ By virtue of the Canada-China treaty, such fees are likely to be exempt from Chinese tax as part of business profits. Moreover, the Chinese tax authorities do not treat fees for commercial advice or assistance as falling within the definition of "fees for the use of proprietary technology," provided that such services do not involve the transfer of "proprietary technology."¹⁶⁴

In addition, employees of a Canadian company who travel to China to meet and negotiate contracts with Chinese customers are taxable in China only if they spend more than 183 days in a taxation year in China.

The Chinese importer pays customs duty and VAT on the importation of goods into China; if the imported goods are luxury goods, the Chinese party may also be subject to the consumption tax. Services provided by Canadian companies in China are generally subject to VAT (repair and processing services) or business tax (other services). Taxes are generally withheld by the Chinese payer.

Compensation Trade

In a typical compensation trade, or countertrade project, a foreign company provides machinery, equipment, or technology to a Chinese entity and receives payment in kind. The payment in kind may consist of goods

¹⁶¹ The US treaty with China, on the contrary, like all tax treaties that the United States has signed, does not allow for tax sparing, so that credits are allowed in the United States only for taxes *actually* imposed and paid in China.

¹⁶² Canada-China treaty, article 21(2).

¹⁶³ FIT regulations, article 67.

¹⁶⁴ FIT regulations, article 59; and proprietary technology provisions.

produced with the transferred assets, other goods, or some combination of the two. The foreign company usually resells these goods on the international market or in its domestic market.

Compensation trade can be broadly characterized in two ways. The Chinese sometimes describe compensation trade as a loan transaction: the foreign company “lends” the machinery or equipment to the Chinese unit and the loan is repaid in kind. Under this interpretation, the value of the repayment in kind represents both principal and interest. Alternatively, compensation trade may be viewed as an instalment sale of the machinery or equipment, or what the Chinese term a “deferred payment” arrangement. Under this interpretation, each payment in kind represents a partial payment of the purchase price and an interest component.¹⁶⁵ The foreign company may also provide some training or technical services together with the equipment. In that case, a portion of the payment in kind is considered to be payment for these services. In addition, the portion of the payment in kind attributable to any transferred technology may be viewed as a licence fee or, in the Chinese terminology, a “fee for the use of proprietary rights.”

Although the FIT law does not refer explicitly to compensation trade arrangements, Chinese tax authorities have indicated that they do not view compensation trade arrangements as creating establishments. Therefore, only withholding tax is imposed on the portion of the payments that represents payments of interest.¹⁶⁶ Unless the technology or service fees can be regarded as “royalties” under article 12(3) of the Canada-China treaty, payments in kind that represent such fees are not taxable in China. Certain exemptions from withholding tax may be available in compensation trade transactions. For example, interest has been exempt from tax where both principal and interest payments in a compensation trade arrangement are paid in kind.¹⁶⁷ Although no specific exemption exists for technology fees paid in kind under compensation trade arrangements, the rules granting special “preferential terms” often extend to compensation trade transactions.¹⁶⁸

¹⁶⁵ Related to this characterization is a lease sale or hire purchase, where each payment in kind includes a “lease fee” consisting of interest and a partial payment of the purchase price of the equipment.

¹⁶⁶ The FIT regulations, article 62, appear to contemplate such an application of the withholding tax, stating that income on which the withholding tax is to be applied may include payments made in kind. The Chinese payer in this type of situation apparently withholds products equal in value to 20 percent (or the relevant lesser amount) of the total payback and converts these into cash for payment to the tax authorities.

¹⁶⁷ Interest regulations, articles 2(5) and 3.

¹⁶⁸ State Tax Bureau Notice on the Question of Levying Tax on Compensation Trade and Royalties for Technology, *Cai Shui Wai Zi* no. 132, May 25, 1987; and proprietary technology provisions, article 1. Because in-kind payments save foreign exchange for China, their use will be a positive factor in determining whether technology is being offered on “preferential terms.” If the “advanced” test is satisfied, the technology may also be eligible for the withholding tax exemptions. See Ministry of Finance Notice, *Cai Shui Zi* no. 65, March 9, 1983.

Chinese VAT or business tax will not apply to the Canadian company on products received from China in compensation trade transactions and their resale abroad.

Leasing

Chinese enterprises are becoming increasingly interested in leasing foreign capital equipment. Among other advantages, leasing may enable them to avoid some of the foreign exchange and import licence regulations that hamper the outright purchase of this type of equipment. While rental payments are generally taxable to the foreign lessor at 20 percent under the FIT law, special tax treatment applies to “lease-sale” or “hire-purchase” transactions.

In “lease-sale” transactions, a leasing company rents a piece of equipment to a Chinese entity, with ownership ultimately passing to the Chinese entity. Hence, in contrast to an actual “rental” transaction, the payments made by the Chinese in a “lease-sale” arrangement may contain three elements:

- 1) a portion attributable to the “principal” or purchase price of the equipment;
- 2) a component that may be characterized by the parties as a “lease” fee but is in fact interest, which is usually computed at a rate that represents the leasing company’s cost of financing the purchase of the equipment in question; and
- 3) a service charge or spread imposed by the leasing company over its own cost of funds—that is, over the interest component mentioned above.

The Chinese tax implications for Canadian companies involved in lease-sale transactions are as follows:

- 1) The portion of payments attributable to the purchase price is not taxable.
- 2) The withholding tax on the rental or interest component is reduced to 10 percent. In certain circumstances, interest in lease-sales concluded between 1983 and 1995 may be exempt from withholding tax.¹⁶⁹
- 3) Service fees are probably not taxable as a “royalty” within the meaning of the treaty unless the services are considered part of a transfer of technology.

Leased assets in China are unlikely to constitute a permanent establishment of the Canadian lessor; as a result, the profits earned through these transactions are taxable only in Canada.

Licences of Technology

Obtaining foreign technology is one of the main policy objectives of the Chinese government. During the past decade, China has developed

¹⁶⁹ See *supra* footnote 113 and the accompanying text.

laws to protect intellectual property, such as the patent law,¹⁷⁰ the trademark law,¹⁷¹ and the copyright law;¹⁷² it also has signed some multilateral conventions.¹⁷³

The granting of rights to Chinese enterprises to use a patent, trademark, franchise, copyright, or knowhow is an important way for Canadian companies to exploit business assets in China without establishing a full presence there.¹⁷⁴ If the Canadian company does not have a Chinese permanent establishment to which assets are attributable, Chinese tax on royalties is limited to 10 percent under the Canada-China treaty. The withholding tax may be waived if the technology is “advanced” and offered on “preferential” terms. By virtue of the tax-sparing clause of the treaty, the Canadian company is deemed to have paid Chinese tax at 15 percent for Canadian tax purposes.

Income from the sale or licence of computer software also may be taxed as royalties.¹⁷⁵ There are three possible situations involving computer software. In the first, a Canadian company sells computer programs to the Chinese, with or without computer equipment, and the Chinese use the programs as desired. The technology that would enable the Chinese to write and develop programs of their own is not transferred. This situation is regarded as a simple sale of goods, and the resulting income is not taxable in China. In the second situation, technology for creating computer programs is transferred to the Chinese, and the resulting income is treated as fees for the use of proprietary technology. In the third situation,

¹⁷⁰ Patent Law of the People’s Republic of China, promulgated by the National People’s Congress on March 12, 1984 and amended on September 4, 1992. The implementing regulations for the patent law were promulgated by the China Patent Bureau on January 25, 1985. See also Regulations for the Administrative Protection of Pharmaceutical and the Administrative Protection of Agro-Chemical Products, promulgated by the State Pharmaceutical Administration and the Ministry of Chemical Industry, respectively, on December 19, 1992.

¹⁷¹ Trademark Law of the People’s Republic of China, promulgated on August 23, 1982 by the National People’s Congress and amended on February 22, 1993. The implementing regulations for the trademark law were promulgated on March 10, 1983 and amended on January 13, 1988 and July 28, 1993 by the State Administration of Industry and Commerce. For trademark protection, it is essential that the trademark be registered in China.

¹⁷² Copyright Law of the People’s Republic of China, promulgated by the National People’s Congress on September 7, 1990. The implementing regulations for the copyright law were introduced by the State Council on June 1, 1991. See also Computer Software Protection Regulations introduced by the State Council on June 4, 1991.

¹⁷³ China is a party to the Universal Copyright Convention, the Berne Convention for the Protection of Literary and Artistic Works, the Convention for the Protection of Phonogram, the Madrid Agreement Concerning the Registration of Trademarks, and the General Agreement on Tariffs and Trade Intellectual Property Rights Agreement.

¹⁷⁴ For further discussion, see Catherine A. Brown, *Tax Aspects of the Transfer of Technology: The Asia-Pacific Rim*, Canadian Tax Paper no. 87 (Toronto: Canadian Tax Foundation, 1990), 237-90.

¹⁷⁵ State Tax Bureau Reply to the Question of Imposing Tax on Fees for the Use of Computer Software Provided by Foreign Businesses, *Cai Shui Wai Zi* no. 235, August 29, 1986 (herein referred to as “the computer software notice”).

computer software is transferred together with patents, copyright, or knowhow and can be used only in specified situations. Licence fees are taxable under the Chinese withholding tax at 10 percent unless the earning of the fees is attributable to a permanent establishment of the Canadian company in China.

The Canadian company may also be subject to business tax at the rate of 5 percent on licence fees.¹⁷⁶ It is unclear whether computer software is regarded as “goods” for VAT purposes.

Representative Office, Business Agent, or Branch

To explore and pursue business opportunities in China, a Canadian company may decide that it needs a permanent presence in the country. Having made this decision, the company may choose several approaches, including establishment of its own representative office or branch, retention of a business agent, or appointment of an exclusive agent in China.

Representative Office

Canadian companies may set up representative offices in China, which must be registered with the Chinese government.¹⁷⁷ Representative offices provide mainly liaison or information-gathering services; some, however, conduct business activities and are engaged in the negotiation of sales contracts or perform various services that may be compensated in the form of commissions and fees.¹⁷⁸

The Chinese tax consequences for a representative office depend on the nature of its activities. A representative office of a Canadian industrial or manufacturing company is not considered a “permanent establishment” if it confines its activities to liaison, research, and services of a preparatory or auxiliary nature for the “head office” on a

¹⁷⁶ If the Canadian company has no establishments in China, tax is generally withheld, presumably together with the FIT withholding tax, by the Chinese payer.

¹⁷⁷ Provisional Regulations of the State Council Concerning the Control of Resident Representative Offices of Foreign Enterprises, October 30, 1980; and Measures of the State Administration of Industry and Commerce Regarding the Control of Registration of Resident Representative Offices of Foreign Enterprises, approved by the State Council on March 5, 1983, promulgated by the State Administration of Industry and Commerce, and effective on March 15, 1983 (herein referred to as “the representative office registration measures”).

¹⁷⁸ The representative office registration measures provide that “representative offices of foreign enterprises shall be representative offices that engage in activities that are not direct business operations.” In practice, however, some offices conduct more than just liaison activity and are engaged in actual business. In May 1985, provisions on the taxation of foreign representative offices were introduced in response to the need to distinguish the two types of representative office and to impose income tax on the business profits earned by some representative offices. See Provisional Regulations for Collection of Consolidated Industrial and Commercial Tax and Enterprise Income Tax from Resident Representative Offices of Foreign Enterprises, issued by the Ministry of Finance on May 15, 1985 (herein referred to as “the representative office tax regulations”).

cost-reimbursement basis.¹⁷⁹ However, if the representative office is involved in the negotiation and signing of sales contracts or performs services for third parties or for affiliated members of the same corporate group, as is frequently the case, the representative office is considered a “permanent establishment.”¹⁸⁰ Offices of Canadian accounting firms, law firms, banks, and trading companies are generally deemed to be “permanent establishments” of these enterprises and taxable in China on their Chinese source income.¹⁸¹ If some of the services are performed inside China by the representative office and some outside China by the head office, only the amount attributable to services rendered by the representative office is Chinese source income.¹⁸² Explanatory documentation must be submitted to the local tax authorities, who then determine the amount subject to Chinese tax.¹⁸³ A company with a representative office in China that cannot provide accurate evidence of the office’s costs and expenses may be taxed on an amount of imputed profit equal to 10 percent of the office’s gross revenue.¹⁸⁴ Representative offices are generally required to substantiate the amount of gross revenue by submitting contracts or invoices.

Canadian expatriates working in a representative office must file tax returns in respect of their employment income if they stay in China for more than 183 days in a taxation year and the representative office is not taxable as a permanent establishment. The chief representative is, however, generally required to file a tax return regardless of the length of his or her stay in China.

Representative offices are subject to VAT and consumption tax on the import of office equipment and other items, with some exceptions in limited

¹⁷⁹ Representative office tax regulations, article 1; Supplementary Provisions Concerning the Question of the Levy of the Industrial and Commercial Consolidated Tax and Enterprise Income Tax on Resident Representative Offices of Foreign Enterprises, *Cai Shui Wai Zi* no. 197, September 25, 1985 (herein referred to as “the supplementary provisions”); and article 5 of the Canada-China treaty.

¹⁸⁰ This is generally in accord with the Canada-China treaty. Article 5(4) of the treaty provides that a permanent establishment will not arise where an office is maintained “solely for the purpose of carrying on activities of a preparatory or auxiliary character.”

¹⁸¹ Representative office tax regulations, article 2; and Ministry of Finance Notice on Several Policy Issues Concerning the Representative Office Tax Regulations, *Cai Shui Wai Zi* no. 122, May 13, 1985, article 6.

¹⁸² Representative office tax regulations, article 4; and FIT regulations, article 6(1).

¹⁸³ The office must submit the relevant agency contract or other “equivalent documentary evidence” in support of its argument for an allocation of income between the China office and the head office. If this evidence is sufficient, the local tax office may allocate 50 percent of income under the contract in question as taxable income in China or, in special cases, determine the appropriate percentage on the basis of the actual circumstances. See Ministry of Finance Notice, *Cai Shui Wai Zi* no. 198, September 19, 1985, article 2.

¹⁸⁴ FIT regulations, article 16. The representative office tax regulations, article 4, provided for a 15 percent deemed profit rate. This rate was reduced to 10 percent in October 1986. See Ministry of Finance Notice, *Cai Shui Wai Zi* no. 290, October 6, 1986.

cases.¹⁸⁵ In addition, gross revenues generated by representative offices are taxable under the business tax, normally at the rate of 5 percent.

Agent

Canadian companies may do business in China through one of the many foreign trading companies or consulting firms that have representative offices in China. As discussed above, these trading or consulting firms are taxable under the FIT law on the commissions and other fees generated by their representative offices. A Canadian company that does business with such a firm may be deemed to have set up a business agent in China. The agent's activities may give rise to a "permanent establishment" of the Canadian company if the agent has the authority to conclude contracts on behalf of the company. However, if the agent is a broker, general commission agent, or any other agent of an independent status, the Canadian company is not liable to Chinese income tax, provided that the agent acts in the ordinary course of its business.¹⁸⁶

Branch

Actual branch operations of foreign companies, as opposed to representative offices, are not common. Until the introduction of the company law¹⁸⁷ in 1994, Chinese laws did not generally permit foreign companies, other than banks, to establish branches in China. The company law allows foreign companies to carry on business in China through a branch or branches. To establish a branch, a foreign company must

- file an application with a competent government department and submit relevant documents such as articles of incorporation;
- register with the State Administration of Industry and Commerce and obtain a business licence;
- appoint a resident representative or agent; and
- allocate a specified amount of funds to the branch commensurate with its business activities.

Branches of Canadian companies are considered "establishments" under the FIT law and "permanent establishments" under the Canada-China treaty. Profits derived through branches are taxable on a net basis. China does not impose any branch tax or other tax on the repatriation of branch income to Canada. This does not, however, necessarily make a Chinese branch a preferable form of doing business compared with a FIE, since dividends paid by FIEs are currently exempt from withholding tax.

¹⁸⁵ Regulations of the General Administration of Customs of the People's Republic of China on the Import and Export of Articles by Representative Offices and Personnel of Foreign Enterprises and Foreign Media, issued on May 1, 1984.

¹⁸⁶ FIT regulations, article 4; and Canada-China treaty, articles 5(5) and (6).

¹⁸⁷ The People's Republic of China Company Law, adopted by the National People's Congress on December 29, 1993 and effective July 1, 1994.

Compared with FIEs, Chinese branches are unattractive to Canadian companies from both the Chinese and the Canadian tax perspectives. Unlike FIEs, branches are ineligible for most of the tax incentives provided under Chinese law. For example, branches are not eligible for tax holidays, the tax reduction in special areas, or the reinvestment tax refund. The only incentive available to branches is the reduction in the tax rate to 15 percent where the branch is engaged in productive activities in the SEZs. Canadian companies are taxable in Canada on income earned through Chinese branches, with a credit for any Chinese tax on the branch income. Because China applies a lower tax rate (30 percent) than Canada to branch income, branch income ends up being taxed at the higher Canadian rate. On the other hand, a Chinese subsidiary generally produces no immediate Canadian tax liability for its Canadian parent.

Contracted Projects

A Canadian company whose business activity consists of what the Chinese call a “contracted project,” such as a construction, installation, assembly, or other service project, is deemed to have an “establishment” in China by virtue of the project “site.”¹⁸⁸ Under the treaty, however, the income is not taxable in China unless the particular project lasts more than six months. To the extent that the income is not treated as business profits of the Canadian company but as fees for the transfer of technology and related services, Chinese withholding tax will apply in the absence of special exemptions. The precise treatment of a contracted project depends on the type of project.

One type of contracted project includes the sale by a Canadian company of equipment to a Chinese entity and the location of employees at the customer’s site for a period of time to provide ancillary installation, construction, training, or related services. The project does not constitute a permanent establishment unless it lasts more than six months. If the project is considered a permanent establishment, the Canadian company is subject to Chinese tax on its income from services, but not from the sale of the equipment.

Another situation may involve a Canadian company that contracts with a Chinese entity for a construction project, seismic survey, other service project, or offshore oil exploration, with perhaps the incidental sale of some machinery or equipment. The Chinese tax authorities have generally considered the service project a permanent establishment if it continues for more than six months.¹⁸⁹ In this situation, the Canadian company may

¹⁸⁸ The Canadian company is required to register the contract with the local tax authorities where the contracted project is located, file a tax return, and negotiate with the tax authorities the basis of computing its tax liability. If the Canadian company has more than two contracted projects, with the approval of the tax authorities, the company may file a consolidated return in respect of all of its projects. See FIT regulations, articles 89 and 90.

¹⁸⁹ Canada-China treaty, article 5.

pay Chinese tax on its net income; if it is unable to substantiate the costs and expenses, its net income is deemed to be equal to 10 percent of total revenue from the project.¹⁹⁰

A third situation involves a Canadian company that provides on-site installation, training, or other technical services in conjunction with the transfer of technology to China. At present, the Chinese tax authorities do not generally consider this activity to constitute a permanent establishment.¹⁹¹

A Canadian company that subcontracts project work in China to another foreign company is responsible for withholding business tax from its payments to the latter.¹⁹²

Equity Joint Ventures

Equity joint ventures are limited liability companies in China. An equity joint venture normally has two partners: the foreign partner and the Chinese partner. The EJV law requires the foreign partner to own at least 25 percent of the equity in the venture. Equity joint ventures are subject to the FIT; and, as discussed earlier, Canadian expatriates working in a Chinese-Canadian joint venture are subject to the IIT.

An equity joint venture is a company for both Chinese and Canadian tax purposes. The Canadian participant in the venture is treated as having a foreign affiliate in respect of its interest in the joint venture. Dividends received by the Canadian company from the joint venture are exempt from Chinese withholding tax. Such dividends are considered to be paid out of the joint venture's "exempt surplus" and are not taxable to the Canadian company.¹⁹³

The VAT, consumption tax, and business tax apply to equity joint ventures. The Canadian participant in a joint venture that imports items in connection with its participation in the venture may be exempt from VAT

¹⁹⁰ FIT regulations, article 16; State Tax Bureau Supplementary Notice on the Levy and Calculation of Tax for Foreign Businesses Contracting for Project Work, Providing Labour Services or Purchasing or Manufacturing Equipment and Materials for the Chinese, *Cai Shui Wai Zi* no. 23, January 21, 1988, article 6 (herein referred to as "the project and labour provisions"); and State Tax Bureau Notice Regarding Several Questions on Taxation of Foreign Investment Enterprises and Foreign Enterprises Engaged in Co-operative Offshore Oil Exploration and Engineering Projects and Services, *Guo Shui Fa* no. 191, November 27, 1991, article 6.

¹⁹¹ To the extent that service or related income received in any of the above-discussed situations is deemed to involve fees for the use of proprietary technology, it will be taxable under the withholding tax in accordance with the FIT law.

¹⁹² Business tax law, article 11. If the deemed profit rate has been adopted for the latter, the Canadian company must also withhold the income tax. See the project and labour regulations, article 4.

¹⁹³ Canada-China treaty, article 21(1)(b). This provision states that for the purposes of the treaty, the Canadian participant in a Chinese-Canadian joint venture established according to the law of China concerning joint ventures with Chinese and foreign investment shall be treated as having a foreign affiliate in respect of its interest in the joint venture.

or consumption tax.¹⁹⁴ Export sales by joint ventures, as well as by all other entities, are currently exempt from consumption tax and subject to zero-rate taxation under the VAT.

Cooperative (Contractual) Joint Ventures

In cooperative joint ventures, also known as non-equity or “contractual” joint ventures, the Chinese and foreign parties contribute capital or technology and share profits and losses according to a contractual formula. In some cases, the profits are paid in kind with the goods produced by the venture.¹⁹⁵ At the end of the operating term of the joint venture, fixed assets are normally transferred to the Chinese partner at a nominal price.

For Chinese tax purposes, a cooperative joint venture may be established as a “legal person,” with the status of a limited liability company, or as a “partnership.” Where the venture is incorporated as a legal person, it is a separate taxable entity, much like any other FIE. Any dividends paid by the venture to the foreign investor are exempt from withholding tax. Where the venture is not incorporated as a legal person, the parties may elect to have it taxed as one taxpayer. In a “classic” contractual joint venture that is not regarded as a separate legal person, the Chinese and foreign parties calculate and pay tax separately; the Chinese party pays tax under relevant domestic tax legislation;¹⁹⁶ and the foreign party is deemed to have an establishment in China. As a matter of practice, some cooperative joint ventures are treated as partnerships: the venture is treated as a unit for calculating taxable income, and the parties pay tax separately on their respective shares of its income.

For Canadian tax purposes, it is crucial to determine whether a Chinese-Canadian cooperative joint venture is a foreign affiliate. The position of Revenue Canada is that if the Chinese entity possesses the characteristics of a company, such as a separate identity and limited liability, the joint venture will be considered a company.¹⁹⁷ A cooperative joint venture with the status of a legal person is likely to be considered a foreign affiliate of the Canadian participant, whereas a partnership joint venture is not.¹⁹⁸ If the joint venture is not considered a foreign affiliate, the Canadian

¹⁹⁴ See *supra* footnotes 133 and 134.

¹⁹⁵ Foreign companies receiving their profits in kind calculate their gross income on the basis of the sales price to a third party or by reference to the prevailing market price of the goods in question. The “market price” refers to the current sales price in China of the goods, but this price will be used only if no actual third-party sale takes place. FIT regulations, article 12.

¹⁹⁶ Provisional Regulations of the People’s Republic of China on Enterprise Income Tax, promulgated by the State Council on December 13, 1993.

¹⁹⁷ Revenue Canada, Taxation, *Interpretation Bulletin* IT-343R, “Meaning of the Term Corporation,” September 26, 1977.

¹⁹⁸ Although the treaty clearly provides in article 21(1)(b) that an equity joint venture is a foreign affiliate of the Canadian participant, the treaty is unclear whether a cooperative joint venture with the status of a legal person also may be considered a foreign affiliate. The treaty was signed in 1986 before the CJV law was introduced.

participant is liable to Canadian tax on the income earned through the venture with a credit for Chinese tax paid. Unless the tax-sparing clause of the Canada-China treaty applies, there is no credit available for Chinese tax forgone under various tax incentive provisions of the FIT law. Even if the Chinese tax is deemed to have been paid, the Canadian company may still be liable to Canadian tax since the Canadian rate is higher.

The treatment of cooperative joint ventures for purposes of VAT and other taxes is similar to that of equity joint ventures.

Wholly Foreign-Owned Enterprises

Wholly foreign-owned enterprises are enterprises that are established exclusively with foreign capital. Under Chinese law, a wholly foreign-owned enterprise is a legal person and not a branch of the foreign company. Wholly foreign-owned enterprises are generally treated in the same way as equity joint ventures, except with respect to tax incentives that apply only to the latter. For example, only equity joint ventures engaged in port construction outside the SEZs may be taxed at the reduced rate of 15 percent.¹⁹⁹

Holding Companies

A Canadian company may establish a wholly foreign-owned enterprise in China in the form of a holding company that in turn invests in other projects in China. This arrangement is becoming increasingly common. Holding companies are not taxable on the profits or dividends they receive from other Chinese enterprises or FIEs in which they invest. To the extent that such holding companies have other taxable income subject to the FIT, they may not deduct expenses or losses incurred in the generation of such tax-free dividends from their taxable income. There is no consolidated taxation of a holding company and its "subsidiaries." The FIT law has no provision that allows tax-free corporate reorganizations. In practice, however, where a Canadian company transfers its interest in an equity joint venture to the holding company on a cost basis, the Chinese tax authorities usually do not seek to tax the transaction. Consent of the authorities, however, must be obtained before the reorganization takes place.

Chinese-Foreign Joint Stock Companies

A recent development in China is to permit the incorporation of Chinese-foreign joint stock companies.²⁰⁰ Unlike FIEs that are not allowed to issue

¹⁹⁹ FIT regulations, article 73(2).

²⁰⁰ A series of notices has been issued by the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) and the STA to deal with issues concerning Chinese-foreign joint stock companies. They include MOFTEC Notice Concerning Problems in the Examination and Approval of Chinese-Foreign Joint Stock Companies, issued internally on September 23, 1992 and promulgated on October 5, 1993; MOFTEC Notice Concerning Issues in (The footnote is continued on the next page.)

shares to the public, joint stock companies can issue shares through the stock exchanges in China. The Chinese government has permitted the establishment of these companies in industries in which foreign investment is encouraged, especially in large and medium-scale industries. For income tax purposes, provided that 25 percent or more of the equity of the company is owned by foreign investors, a Chinese-foreign joint stock company is treated as a FIE.

Where an existing FIE is reorganized as a joint stock company and the FIE's assets are transferred at fair market value to the company as a capital contribution, any gains realized from the transfer must be recognized as income of the FIE and will be subject to income tax. The company is deemed to have acquired the assets at a cost equal to the fair market value and may deduct or depreciate the cost, depending on the nature of the assets.²⁰¹

CONCLUSION

The form that a Canadian company chooses for its Chinese operation may be influenced by and give rise to various tax and business considerations. This article provides an overview of the Chinese tax system for foreign investment and outlines some general tax implications for various forms of doing business in China. Although the major elements of the tax structure for foreign business are in place, further changes are bound to occur in the near future. For example, the FIT is expected to be consolidated with taxes that are currently imposed on domestic enterprises. Chinese officials are turning their attention to resolving ambiguities, filling in gaps in the legislation, and responding to the myriad situations and complexities that were not anticipated when the statutory framework was being constructed—tasks faced by tax administrators everywhere. If past experience is any indication, administrative policies and practice will be reflected in the future tax legislation. Therefore, it is essential for Canadian companies contemplating doing business in China to consult professional tax advisers who are aware of recent tax developments, in order to ensure that the structure adopted satisfies current needs and offers adequate flexibility.

²⁰⁰ Continued . . .

Respect of the Establishment of Chinese-Foreign Equity Joint Ventures as Joint Stock Companies, promulgated on October 5, 1993; State Tax Administration Notice Concerning the Applicability of Tax Laws to Joint Stock Pilot Enterprises, issued on September 27, 1993; and State Tax Administration Notice on Several Foreign Related Tax Policies Concerning Joint Stock Pilot Enterprises, issued in January 1994 (herein referred to as "the joint stock company tax notice").

²⁰¹ Joint stock company tax notice.