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Tax Analysis

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PRC Tax

SAT strengthens tax administration

Background

The significant drop in fiscal revenue resulting from the global economic downturn prompted the State Administration of Taxation (SAT) to issue a circular (Guoshuifa [2009] No. 114, hereinafter "Circular 114") providing guidance to the local tax authorities to enable them to enhance enforcement efforts with respect to the tax administration of nonresidents and the prevention of tax avoidance, etc.

Key issues

Circular 114 provides mainly for the following：

Tax administration of nonresidents

- Focused inspections where nonresidents send personnel to carry out management, design, certification or consulting services in the PRC
- Special tax audits of nonresidents with respect to the following kinds of income:
  - Income from major construction projects
  - Repatriations of profits and interest paid by domestic entities
  - Proceeds from the transfer of equity

Anti-avoidance

- Accelerate the verification and registration of qualified Chinese-controlled offshore incorporated entities as Chinese resident enterprises to prevent the use of such offshore vehicles for tax avoidance purposes
- Closely monitor enterprises with limited functions and risks (i.e. enterprises that only perform manufacturing, distribution or contract R&D activities) that are set up by multinational groups, with a view to preventing the shifting of foreign operating losses to domestic enterprises

- Collect information on equity transfers from various sources (e.g. the State Administration of Industry and Commerce and its local branches, equity exchanges) in a timely manner with a view to understanding the economic substance of such transactions

- Scrutinize related party transactions in certain industries, including:

  – Financing for highway construction

  – Pharmaceuticals (particularly for valuation of intangibles)

  – Hotel chains (particularly regarding hotel management fees paid to overseas parent companies by four/five-star hotels)

Tax administration of combined filings

- The tax authorities in charge of qualified branch offices of a resident company may request that the tax authorities in charge of the head office urge that office to provide the income tax allocation form.[1] Penalties may apply for failure to provide the form.

- Enterprise income tax will be immediately collected by the tax authorities in charge of branch offices when under-reported sales of branch offices are identified.

Tax administration of large enterprise groups

- Special tax audits will be carried out on certain large enterprise groups.

- Tax audits will focus on the appreciation of fixed assets, the transfer of equity or real estate, overseas investment income, land appreciation tax issues, annuity plans, etc.

Tax administration of the real estate industry

- Closely monitor all taxable activities and collect relevant information on each phase of real estate development (e.g. the transfer of land use rights, the design, construction, sale or lease of property)

- Improve the collection of land appreciation tax by focusing on a review of the development costs of real estate projects

- State and local tax bureau to compare information obtained from enterprise income tax and business tax filings[2] on a regular basis and carry out joint tax audits where any discrepancies or irregularities are identified

Recommendations

Circular 114 indicates that the tax authorities will increase tax enforcement activities. Affected taxpayers should therefore consider the following:

- Where nonresidents send expatriate employees to Chinese related parties, the activities of such employees must be reviewed carefully to determine whether the secondment might create a permanent establishment (see Tax Analysis P81/2009 and P83/2009 for more information).

- Where a domestic entity is involved in an equity transfer, the parties should ensure that the transaction is at arm's length and that relevant reporting and/or filing obligations have been fulfilled (see Tax Analysis P56/2009 for more information).

- Where Chinese subsidiaries only perform manufacturing (toll manufacturing or contract manufacturing), distribution or contract R&D activities with limited risks and functions and incur losses, the taxpayer should evaluate the transfer pricing risks and prepare contemporaneous documentation in a timely manner (see Tax

[1] Qualified branch offices must file provisional enterprise income tax on a monthly or quarterly basis with the income tax allocation form prepared by the head office.

[2] Enterprise income tax and business tax generally are collected by the state tax bureau and local tax bureau, respectively.

Analysis P82/2009 for more information). Meanwhile, the management of such companies should consider mitigating risks in the future through reasonable arrangements.

- Resident enterprises with branches operating in different locations should ensure that the correct income tax allocation form has been provided and that the provisional (monthly/quarterly) enterprise income tax return has been filed, where applicable (see Tax Analysis P23/2008 for more information).

- Real estate enterprises should make a self assessment (focusing on tax calculation for presale income of property, cost calculation, land appreciation tax payment and settlement, etc.) of various phases of property development.

- As the key targets of recent tax audits, large enterprise groups should proactively conduct self reviews to identify tax-related risks and improve their internal tax management.

Depending on what emerges from the steps above, taxpayers may further consider the following: preparing relevant supporting documents for likely inquiries from the tax authorities or voluntarily settling any underpaid tax to minimize tax exposures.

If you require further details on Circular 114 and its impact on your China business, please feel free to contact one of our professionals.

Tax Analysis is published for the clients and professionals of the Hong Kong and Chinese Mainland offices of Deloitte Touche Tohmatsu. The contents are of a general nature only. Readers are advised to consult their tax advisors before acting on any information contained in this newsletter. For more information or advice on the above subject or analysis of other tax issues, please contact:

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