

# Taxation of Foreign Invested Enterprises in the People's Republic of China

As domestic Chinese enterprises, Foreign Investment Enterprises (“FIEs”) are subject to the payment of value added tax (“VAT”) for their sales and corporate income tax on profits. The provisions of certain services such as construction, transportation, finance or insurance services, etc. are subject to payment of business tax (“BT”). Furthermore, special taxes can apply for certain transactions such as e.g. stamp duty and deed tax.

## VAT

The legal basis for the levying of VAT are the *PRC Interim Regulations for Value Added Tax (Amended)* effective as of January 1, 2009 and the *Detailed Rules for Implementing the PRC Interim Regulations for Value Added Tax (Amended)* effective as of the same date. Enterprises and individuals shall pay VAT when they sell goods, provide taxable services in the PRC or import goods into the PRC. The services subject to VAT are limited to the processing, maintenance and repairing of goods.

VAT taxpayers are divided into two types; general taxpayers and small scale taxpayers. Accordingly, different tax rates and calculations of the taxation amount will apply. The VAT payable by a general VAT taxpayer equals the balance between the output-VAT amount and the input-VAT amount incurred during the same period of time. Depending on the exact type of the goods involved, the VAT rate varies between 13% and 17%. For most kinds of goods, the VAT rate of 17% applies.

A small scale VAT taxpayer refers to a manufacturer who has an annual taxable sales volume of less than RMB 500,000 or a distributor or retailer who has an annual taxable sales volume of less than RMB 800,000. A small scale VAT taxpayer is entitled to a lower VAT rate at 3%. However, he cannot credit the paid input VAT charged on imported or domestically purchased materials.

Starting from January 1, 2009, due to the VAT reform, the input VAT or import VAT paid by an enterprise for domestic purchase or importation of equipments for self-use can also be credited against the enterprise's output VAT.

For goods exported by a general VAT payer, generally, such export is exempted from VAT. In addition, a VAT refund from the tax authority can be available so that part or all of the input VAT related to the exported goods can be refunded to the enterprise. There are two methods of calculation of export VAT refund respectively for manufacturing enterprises and trading enterprises. A manufacturing enterprise is entitled to the “exemption, credit and refund” method. A trading company is entitled to the “pay first and refund later” method. Please note that the VAT refund rates vary according to the HS code of the relevant goods and are subject to adjustment by the Chinese government from time to time.

## Business Tax

The legal basis for the levying of Business Tax are the *PRC Interim Regulations for Business Tax (amended)* effective as of January 1, 2009 and the *Detailed Rules for Implementing the PRC Interim Regulations for Business Tax (amended)* effective as of the same date.

Services (except for processing, maintenance and repairing services which are covered by VAT) provided by or provided to an enterprise or individual located within the PRC shall be subject to business tax in the PRC. The taxable services include transportation, construction, finance and insurance, post and telecommunication, culture and sports, entertainment and other service industries. BT is generally levied on the basis of the gross turnover or sales price at rates ranging from 3% to 20%, depending on the type of the services. For most services, a BT rate of 5% applies.



## Surcharges

Starting from December 2010, FIEs shall also pay certain Surcharges calculated at certain percentages of the Business Tax / VAT. The so-called City Maintenance and Construction Tax is calculated at 7%, 5% or 1% of the Business Tax / VAT payment depending on the location of the tax authority (downtown, township areas or other areas). The Education Surcharge is calculated at 3% of Business Tax / VAT payment. There might be other local Surcharges in some cities/provinces. E.g. in Shanghai, there is a so-called River-Management-Fee calculated at 1% of Business Tax / VAT payment.

## Corporate Income Tax

The legal basis for levying of corporate income tax ("CIT") are the *PRC Corporate Income Tax Law* and the *Implementing Rules of the CIT Law* both effective as of January 1, 2008. The new CIT Law and its Implementing Rules have unified the previous two income tax systems respectively for domestic enterprises and FIEs as well as foreign enterprises.

Tax holidays exclusively granted to FIEs established before the publication of the CIT Law, i.e. March 16, 2007 are grandfathered to be used until expiry. The previous preferential rate of 15% for FIEs in some special economic regions and Pudong area is allowed to be increased steadily within 5 years to the current standard CIT rate of 25%.

The CIT Law has abolished most existing tax incentives for FIEs. New tax incentives are provided to both domestic enterprises and FIEs and focus on technology development, energy saving, environmental protection, infrastructure construction and agriculture. The following provides a brief summary of these incentives:

- a) For income derived by a tax resident enterprise from qualified transfer of technology in a tax year, the portion that does not exceed RMB 5 million shall be exempted from CIT, and the portion that exceeds RMB 5 million shall be allowed a half reduction of CIT.

- b) In case of a venture capital enterprise that makes an equity investment in unlisted small-to-medium sized high/new tech enterprises for more than 2 years, 70% of its investment can be used for set-off against the taxable income of such venture capital enterprise in the year after the holding period has reached 2 years. Any portion that is not utilized in this year may be carried forward and is deductible in the following years.
- c) For qualified R&D expenses incurred by an enterprise for the development of new technology, new products and new craftsmanship, the enterprise is allowed to claim, on top of the actual deduction, an additional deduction of 50% of the R&D expenses. Where an intangible asset is formed, the cost of the intangible assets is allowed to be amortized based on 150% of the cost of the intangible assets.
- d) Qualified high/new tech enterprises can enjoy a reduced CIT rate of 15%.
- e) Enterprises that purchase equipments for the purposes of environmental protection, energy or water conservation or production safety will be eligible for a reduction of their CIT payable by 10% of the cost of these equipments.
- f) Income derived from qualified environmental protection, energy and water conservation, infrastructure construction projects can enjoy 3 years full exemption followed by 3 years half reduction of CIT starting from the year when the enterprise begins to obtain income from these projects.
- g) Income derived from most of the agriculture, forestry, animal husbandry, ocean fishery projects as well as service industries directly related with these projects can enjoy CIT exemption without time limit. Income derived from cultivation of flowers, crops for tea and other beverage and spice crop and fish farming can enjoy a half reduced CIT without time limit.

## Important items under the new CIT Law

The new CIT Law and its Implementing Rules further deal with the following important issues:

- a) The CIT Law has introduced the concept of tax resident enterprise ("TRE"). TRE is defined as an enterprise which is established in the PRC under the PRC laws and regulations, or which has its place of effective management in the PRC. TREs will be subject to the PRC CIT for their worldwide income.
- b) The standard CIT rate is 25% down from the previous 33%
- c) The CIT Law has introduced the concept of "deemed sales" which already existed in the current VAT regime. Under such concept, when an enterprise engages in barter trade, or uses its inventories, assets and services for donation, debt repayment, fund-raising, advertising, sample, staff welfare or profit distribution, it may be regarded as having made the relevant sales and shall recognize the income accordingly.

d) Deductions

The CIT Law stipulates that an enterprise can deduct reasonable expenses that are actually incurred and are related to the generation of income. The Implementing Rules further clarify that related expenses refer to expenses directly related with the generation of income, reasonable expenses refer to necessary and ordinary expenses incurred in the course of normal business. It is possible that the taxpayers and the PRC tax authorities may have disputes in practice as to what constitutes reasonable and related expenses. The deduction of certain items may be prohibited or restricted to some limits, such as entertainment expenses, advertisement expenses, donations, amortization of purchased goodwill, management fees and etc.

e) As in the past, losses can be carried forward for 5 years to be utilized and set-off against future taxable income.

f) The new CIT Law pays more attention to anti-avoidance of tax. A thin capitalization rule, controlled foreign company rule, general transfer pricing (“TP”) rules, TP documentation requirements, general anti-avoidance rules are all covered by the CIT Law. After the CIT Law was issued, the Chinese tax authorities have worked many detailed circulars to implement these principles.

## Stamp Duty

According to the *PRC Interim Regulations for Stamp Duty*, effective as of October 1, 1988 and the *Detailed Rules for Implementing the PRC Interim Regulations for Stamp Duty* effective as of the same date, enterprises and individuals who execute or receive taxable documents shall pay stamp duty. Taxable documents include:

Contracts or documents in nature of a contract with regard to purchased and sales, the undertaking of processing, contracting for construction projects, property leasing, commodity transport, warehousing, loans, property insurance, and technology, documents for the transfer of property rights, business accounting books, certificates evidencing rights or licenses; and other documents that are taxable as determined by the PRC Ministry of Finance.

Stamp duty is usually calculated on the basis of the amounts stated in the documents at the rate ranging from 0.05% to 0.1%, depending on the nature of the document. All contract parties have to pay the above stamp duty.

## Deed Tax

In case of any granting, transfer or assignment of land use rights or ownership of buildings, according to *PRC Interim Regulations for Deed Tax* and the *Detailed Rules for Implementing the PRC Interim Regulations for Deed Tax*, both effective as of October 1, 1997, the transferee shall pay deed tax. The deed tax is levied on the basis of the transfer price or deemed price at the rate ranging from 3% to 5%. The exact tax of deed rate is stipulated by the provincial governments.

# Land Value –Added Tax

The legal basis for the levying of Land Value-added Tax (“Land VAT”) is the *PRC Interim Regulations for Land Value Added Tax* effective as of January 1, 1994 and the *Detailed Rules for Implementing the PRC Interim Regulations for Land Value Added Tax* effective as of the same date. Land VAT is a tax on the gains derived from the transfer of land, buildings and associated structures. Land VAT is calculated with progressive tax rates ranging from 30% to 60% depending on the percentage of gains realized.

## Real Estate Tax

The legal basis for the levying of Real Estate Tax is the *PRC Interim Regulations for Real Estate Tax* effective as of October 1, 1986. Starting from January 1, 2009, FIEs are also subject to Real Estate Tax in China.

Real Estate Tax is levied in cities, county towns, state designated townships and industrial and mining areas. Real Estate Tax is payable by the owner of the property rights (lands are excluded). The tax amount is calculated at 1.2% of 70%-90% of the original value of the buildings, or, 12% of the rental in case the properties are leased.

For further information and assistance, please contact

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