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China Tax Insights

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State Administration of Taxation Issues Latest Enterprise Income Tax Practices

On 29 April 2009, the State Administration of Taxation issued a *Notice on the Guidelines to Strengthen the Administration and Collection of Taxes* (*Guoshuifa* [2009] No.85) (Circular No. 85) which set out the practices and standards that taxpayers can expect national and local level tax authorities to implement over the next 12 months.

Circular No. 85 is a relatively comprehensive outline of the SAT's intended practice to the administration of tax collection in China, including in respect of VAT, business tax and income tax. In relation to enterprise income tax, the notice prescribes the following standards/practices:

1. The provisional tax reported in a financial year must be more than 70% of the total tax payable on the annual filing of the same year.
2. Audits will be particularly targeted at enterprises which have incurred losses for more than three consecutive years, have low or variable long-term profits, and which record profits after the end of a preferential tax period.
3. The SAT will intensify its investigation of specified industries, including banking, real estate, steel, restaurants, tobacco, electricity and construction.

The Notice also indicates that SAT will take a more aggressive approach to international taxation, including strengthened enforcement of transfer pricing compliance, utilization of the anti-avoidance rule under the Enterprise Income Tax Law, monitoring the tax compliance of non-PRC residents (including withholding tax obligations), and business tax on payments for services rendered that are remitted outside of China.

This latter point will be critical for many businesses that have for many years structured their business to ensure that fees are paid outside of China to avoid the imposition of business tax, an arrangement that has been especially common in the field of professional services.

Lehman, Lee & Xu is a top-tier Chinese law firm with an associated tax and accounting practice, Lehman Tax & Accounting.

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mail@lehmanlaw.com

www.lehmanlaw.com

Roll-Out of Online 'Fapiao' System Begins

Anyone living or doing business in China knows of the importance of fapiaos – official government invoices intended to provide final proof of purchase of a good or service. Fapiaos are needed to obtain tax deductions, resulting in the development of a black market trade in the slips of paper.

From 1 July 2009, the Chinese government has started experimenting with Internet fapiaos to try and reduce opportunities for tax fraud. Last week the Dongguan Local Tax Bureau issued the first invoice on the Internet, in the first use of a comprehensive scheme to promote Internet invoices. In four pilot cities, Dongguan, Huizhou, Zhuhai and Jieyang, taxpayers may request, issue and inquire about invoices on the Internet.

By next year, Internet invoices will cover all industries and taxpayers will no longer need to go to the Local Tax Bureau for invoices. Authorities hope to see multiple benefits from the new system, both in terms of convenience and fraud reduction.

Stiff Fines and Prison Sentences in Tax Evasion Case

In May 2009, the Beijing First Immediate People's Court announced its judgment in the case of Beijing Guanghui Jiyuan Trade (Guanghui).

Guanghui sold products such as cosmetics, underwear and home electronics via the television and telephone, which were delivered to customers by express post on a cash-on-delivery basis. After collecting the money the postal service company transferred the money to Guanghui.

To avoid taxes Ms. Fu, Guanghui's legal representative, asked the postal company to instead remit the money to her individual bank account. In this way, Guanghui evaded a total of RMB 21.9 million in taxes.

The court found that this was a clear case of avoidance, and imposed a fine of RMB 30 million on Guanghui. Ms. Fu received a jail term of five years imprisonment and a fine of RMB 30 million; Dou, Guanghui's accountant, was sentenced to prison for 30 months and fined RMB 5 million; and Wu, an employee of Guanghui, was sentenced to 12 months' imprisonment and fined RMB 1 million.

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July Tax Briefing:

The 'Related Parties' Concept in China

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As with most tax systems, a critical issue under China's tax laws is the concept of 'related parties', which is comprehensively defined in Chapter 2 of the *Implementation Measures of Special Tax Adjustment (Provisional)* (the 'Measures') promulgated by the State Administration for Taxation on 8 January 2009. In particular, Article 9 of the Measures expands upon the definition provided in Article 109 of the Implementation Regulations of the Enterprise Income Tax Law. Under Article 9, two parties will be related where:

1. One of parties directly or indirectly holds more than 25% of the shares in the other party, or where a third party owns more than 25% of both parties. An indirect holding is a holding through an interposed entity. The party will be deemed to hold the same amount that the interposed entity holds if the interposed entity holds more than 25%. Interestingly, the Measures do not provide for the aggregation of direct and indirect holdings. For example, a party could directly hold 24.5% of the shares in an entity and an interposed entity could hold a further 24.5%, and the parties would not be considered related on a literal application of this aspect of the definition.

2. More than 50% of the paid-in capital of either of the parties is from a loan from the other party, or 10% of the total loans of one party are guaranteed by the other party. However, the Measures do provide an exception for loans from independent financial institutions.

3. Senior management of one party is either appointed by or comprised of members of the other party's senior management.

4. One of the parties' business operations can only be carried on because of the industrial or intellectual property rights granted by the other party. This obviously has a very broad scope and may result in parties involved in ordinary commercial relationships, such as an exclusive OEM arrangement, being characterized as related parties. The SAT has traditionally adopted a very light approach to this limb, but it is important that such arrangements be structured so as to avoid the parties being characterized as related under this limb.

5. One of the parties largely controls the purchase and sales activities of, or the services received by, the other party.

6. Other relationships where one party has actual control over the other party, despite not satisfying the formal shareholding requirements. It should be noted that the broad nature of this aspect of the definition will mean that the parties referred to in the example in point 1 above could still be regarded as "related" under the Measures.

Page 2 of each edition of *China Tax Insights* is dedicated to a briefing on a particular aspect of Chinese tax law, with a focus on issues affecting international transactions.

When will a Subsidiary be Deemed A Controlled Foreign Company?

A controlled foreign company is a foreign enterprise established in a country with a tax rate lower than 12.5%, whose profits are not distributed or are distributed at a reduced rate due to non-reasonable business purposes, and is controlled by a resident enterprise, or by a resident enterprise jointly with a resident individual.

Under the *Implementation Measures of Special Tax Adjustment (Provisional)* (the "Measures"), the test for "control" has two limbs. Article 76 of the Measures defines 'control' as meaning that a Chinese resident shareholder:

1. Directly or indirectly holds no less 10% of the voting shares in the foreign company in any single day of a taxable year; and
2. Jointly holds no less than 50% of the total shares of the foreign enterprise.

Where this test is satisfied the foreign subsidiary will be deemed a controlled foreign company, and any non-distributed income will be attributed to the Chinese resident taxpayer(s).

Lehman, Lee & Xu's corporate and international taxation team, in association with Lehman Tax & Accounting, offers clients unrivalled and comprehensive services relating to both Chinese and international taxation matters, and provides a high standard of technical expertise with a practical and commercial approach.

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