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Are you ready to face the tax man?

A recent survey found that out of 3,200 Representative Offices (tax) audited in China, over one [third \(1/3\) had understated individual and corporate tax liabilities](#) of various forms over the year. The outcome - \$8 million in extra tax revenue when investigated by the tax bureau.¹ The lesson - all companies in China are facing greater chances of being audited by tax the taxation authorities.

Such is the rhetoric or the 'reality' facing the business community in China at present. Some say justifiably so, explaining - "if you are reaping profits from operating in China, then you should pay tax according to the laws, thereby giving something back to the community."

The taxation environment in China is [becoming increasingly stringent](#) and many companies are still operating illegally. This is extremely dangerous. Not only have the tax authorities been given more powers and access to more wide-ranging penalties, they are also gaining access to greater information to discover such fraudulent activities and more resources to investigate business activities.

Accounting to understate profits may have worked well in the ill-regulated and fragmented tax collection system of the past. However, [recently there has been a surge on auditing of transfer pricing agreements](#), especially where foreign enterprises are party to the contract, offshore interest payments are now being heavily scrutinized against the prevailing (annual) commercial rate in the P.R.C (5.08%) with only this amount deductible for tax purposes, and government departments are beginning to work together to share information.

Many Foreign Invested Enterprises are, however, operating legally and paying all taxes due. The majority of companies use legitimate 'arms length' transfer pricing arrangements to repatriate profits, enter into loan arrangements at commercial rates and realise full profits in China, on which they pay taxes. There are over 400,000 FIEs currently invested in China, which gives the [tax bureaus a lot of incentive to double check](#).



The delicate balancing act!

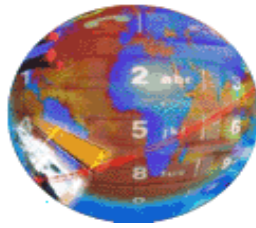
This Friday (8th November, 2002) the Chinese government faces arguably the largest challenge in the past 54 years - the top three leaders are likely to step aside for a new breed of politicians. Hu Jintao (proposed replacement to Jiang Zemin) has assisted the government in [balancing](#) the three represents (san ge dai biao), which include the Communist Party's embrace of private businessmen, against the desire to maintain a socialist-market economy.

At the same time, Li Peng's replacement is going to have to balance China's legislative development and congress in light of [WTO commitments and internal expansionary policies](#). It is at this political grassroots level where such balancing acts become even more important for FIEs.

On a day-to-day basis, China is trying to balance aggressive infrastructure and development projects with a changing tax base and rapid economic policy development. Not only are local and state tax departments under pressure to help build the national public kitty, but their tax bases are being shifted and eroded at the same time. A number of the major recent changes include:

- [Falling import duties in line with WTO commitments](#): "Most Favoured Nations Import Duties" have fallen from an average of 42% in 1992 to an average of 12% in 2002.² WTO commitments will further reduce this and will begin to eat away at the "General Customs Duties" - eroding an even larger slice of the taxation pie.
- [Cutting back of preferential tax treatment policies](#): With the development of the economy and improvements to the legal system, the government is now trying to shift its tax incentives from a geographical regime to an industry-oriented system, which may better serve the interest of the whole economy. This has adversely affected certain municipalities such as coastal cities which rely on the tax policies to induce investment.
- [A shift of emphasis away from Business Tax \(BT\) to Value Added Tax \(VAT\)](#): The widening scope of VAT will shift tax revenue away from BT, which is collected at local tax bureaus, to VAT, which is collected at state tax bureaus. This will create issues with budget allocations, especially for high-infrastructure spending municipalities such as Beijing.

Statistics from the tax department indicate [tax avoidance of up to 50% in some areas](#). To combat this a number of circulars have been issued by the State Administration of Taxation (SAT) which are aimed at cracking down on avoidance, increasing intensity on reviewing individual income tax, and clamping down on various industry groups.



The reality

The fact that the SAT has openly targeted foreign companies and high-income earners (above RMB 100,000 annual salary) has certainly raised a bit of a stir within the expatriate community in China. To back these government directives up, the SAT has also been granted greater powers and information including:

- If a tax payer fails to complete tax registration procedures, the tax bureau can request the Administration Bureau of Industrial and Commercial ("ABIC") to **cancel the business license** that was issued.
- The penalties applicable to underpaid tax have changed. The old system provided for penalties up to 5 times the tax payable as well as late payment interest. The difficulty with this system for the Government was that the tax authorities were often negotiable on the penalty because of the burden of interest chargeable, which was calculated at 0.2% per day (73% per annum).

The **new system provides for a penalty of above 50% to below 5 times tax payable**, as well as interest payable daily at 0.05% (18.25% per annum). The new system provides for a minimum payable penalty, which reduces local tax bureau discretion, and therefore tax payer negotiability.

- Another **significant change relates to information exchange**. Previously Government bureaus operated independently with no legal requirement to share information. Under the new rules the ABIC are required to inform the tax bureau of new registrations and the tax bureau have an obligation to inform ABIC should proper registration with them not take place.
- **Additionally, the immigration department is due to be linked with the tax bureau, which has rattled the foreign communities more than any other change. In fact, the legal representative of a corporate taxpayer or an individual taxpayer with overdue tax liabilities, penalties and/or interest due could be stopped from leaving the country.**



Tax is also a matter of good corporate governance ...

Companies in China must be especially careful to be seen as being good corporate citizens in the new tax environment. Not only are companies up for large penalties if they break the law, but the tax authorities are now developing a database to record companies' tax compliance history. **Three categories have been developed in which companies will be now classified.**

This 'categorisation' of enterprises involves input from tax bureaus, banks, government bodies (e.g. Ministry of Finance), bureau of auditing, credit agencies, amongst others.

Category A - Companies who have demonstrated outstanding corporate governance, especially in taxation. Such companies are provided preferential treatment and basically left alone by the SAT.

Category B - Companies which have demonstrated observance to corporate governance standards and have generally abided by the rules and regulations. Entities in this category are subject to "light" supervision and audit inspections.

Category C - Such companies have been found in breach of the law and regulations. These companies are targeted by tax authorities and are under heavy investigation for tax audits.

The process of categorisation is only in its initial stages of implementation, but it does certainly indicate initiative from the [SAT and government to tighten controls](#). As competition on the mainland grows and public information bureaus develop, corporate citizenship will become an increasingly important factor of successful business in China. An "Enron" case is not likely to happen on the same scale in China in the near future, but getting on the wrong side of the tax departments could certainly have the same devastating results.



The final word

For decades now taxation in China has essentially been negotiable. Local municipalities were provided great powers to offer tax incentives to foreign investors, and late/underpaid taxes could be sorted out through negotiation. This certainly not the case any more.

[Tougher penalties, targeting of foreign companies and a more integrated tax administration system are certainly forcing many companies in China to reexamine their books.](#)

Many companies are now re-examining their past years' statutory audits to ensure that they **were** actually in compliance, regardless of signed auditor reports.

The new "[Accounting System for Business Enterprises](#)" (applicable to all FIEs in China as of January 1, 2002) has brought China closer into line with International Accounting Standards (IAS) and strengthened financial regulation. Firms need to adhere to these new rules and to be more stringent in their financial diligence, documentation and controls. Amongst other requirements, companies should ensure they can [prove inter-related party transactions](#) were conducted at 'arms length', costing of raw materials was 'fair' and their accounting reports have been upgraded in line with the new accounting requirements.

At present the tax department is somewhat more understanding if [companies volunteer information](#) and pay-back any underpaid/unpaid taxes. This period can act as a window of opportunity to clear up any skeletons in the closet. It should also be noted that the tax departments can go back 10 years to check tax records and appropriate documentation.

Given the issues discussed above, there is certainly "no time like the present" to sort out taxation issues in China. The government is getting serious about tax ... and peeling back the layers to find it.

Russell Brown, Partner, Beijing.

Note:

1. *China Prosperity Supervision Centre and CCTV China Economy Report , 2002.*

2: *CPA Taxation Laws (shui fa), Economics Science Press, Jingji kexue chu ban she, 2002.*

Special Seminar Opportunity - "Accounting System for Business Enterprises"

LehmanBrown China is pleased to announce a seminar to explain the inner workings of the new "Accounting System for Business Enterprises". The seminar will be held in Beijing from November 28th to 29th.

These seminars present an opportunity for bookkeepers, accountants, financial managers and directors, as well as other interested parties, to get up to date on the changes and application of the new Accounting System for Business Enterprises in China which is mandatory for all companies in China from January 1, 2002. With the crackdown on taxation, especially for FIE companies, currently underway this seminar is integral for anyone preparing, interpreting or using financial statements in the P.R.C.

The seminar will also cover certain topical business issues in China at present including changes to taxation regulations, FOREX regulations and other issues applicable to FIEs in China.

For registration information visit: www.lehmanbrown.com/Seminars.htm or for phone registration call: **Rachel Wan, Tel: (86 10) 8532 1720** today.

Space is available for a maximum of 15 participants at the 2 day seminar, so be sure to book early.

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