Income tax considerations for doing business in China

There is no doubt that China has become an important trading partner of Australia and small businesses are increasingly venturing into China.

When doing business in China, you have to consider income tax issues.

Forms of business

Companies are the most common form of doing business.

The Company law of the People's Republic of China (PRC) and the regulations issued by the local government must be considered when establishing a company.

For foreign investment under Chinese foreign investment law and regulations, there are typical three forms such as Chinese-foreign Equity Joint Ventures (EJV), Chinese-foreign Cooperative Joint Ventures (CJV) and Wholly Foreign-owned Enterprises (WFOE).

An Equity Joint Ventures is a limited liability company and its net profits are distributed to the parties in proportion to the ratio of the capital contribution.

In contrast to an EJV, a Cooperative Joint Venture is more flexible in terms of profit sharing and allocation of duties and responsibilities.

The Wholly Foreign-owned Enterprises has become the most popular form due to enhanced security in the protection of intellectual property. However, the WFOE will lack the experience and network of a Chinese partner, which can be extremely important.

Foreign investors may also establish a representative office. However its activities are restricted to non-profit making activities.

Following key legal and commercial developments in China, there has been an increased use of Foreign Invested Partnerships (FIP), due to the flexibility in establishment procedures, capital contributions and the increase or reduction of capital.

Enterprise Income tax (EIT)

Enterprise Income Tax Law (EITL) came into effect on 1st January 2008, which unified the two former corporate income tax systems.

The above entities except Foreign Invested Partnerships are resident enterprises and hence they shall pay Enterprise Income Tax (EIT) on its income from sources within and outside the PRC.

Foreign Invested Partnerships' tax treatment is very different from the common understandings of the flow through entity, although FIP established under the PRC Partnership Law is not subject to EIT and each partner is a taxpayer.

For example, the partnership loss is locked in at the partnership level and the partner cannot use its share of loss.

In general, the EIT tax rate is 25% with some exceptions. To name a couple, a reduced rate at 20% is applicable to qualified small-scale enterprises with low profitability and State encouraged high and new technology enterprises are subject to a reduced rate of 15%.

From February 2010, the State Administration of Taxation (SAT) issued a circular to require a foreign representative office to set up accounting books and accurately calculates its taxable revenue and taxable income based on the matching principle of its functions and risks.

Resident companies are taxed on worldwide income, including capital gains.

Dividends, interest and royalties, paid to non-residents, may be subject to a 10% withholding tax, depending on whether non-resident enterprises have permanent establishments.

If income received triggers final withholding tax, there should be no filing requirements.

China has extensive network and concluded over 90 tax treaties.

A lower rate might be applicable if the relevant tax treaty so specifies. Despite the legal authority of the tax treaties, the i nterpretations of treaty provisions are often a challenge.

The EITL also contains various anti-avoidance provisions such as transfer pricing, thin capitalization, controlled foreign company, general anti-avoidance provisions (GAAR) etc.

China's tax base

It has been a long-standing practice for many foreign investors to hold the Chinese investment by interposing holding companies to claim treaty benefits or avoid capital gains tax on exit.

SAT has issued a number of tax circulars to address treaty shopping and indirect disposal of Chinese companies by enacting GAAR to protect its tax base. All these circulars apply retrospectively from 1 January 2008.

It is worth noting that there might be some opportunities to restructure the Chinese investment into a more efficient structure.

Need more information?

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