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PRC tax management and characterization of PRC tax regime

In the past, risk management of investment in PRC has been focused on how to build good relationship with local government authorities by grasping PRC own commercial practice and operation conditions. However, PRC government currently promotes development of legal system and ensured implementation as an advanced country. This movement is accelerated along with a participation of WTO. In particular, officers of related government authorities of newly advanced industrial development areas (tax authorities, administration committee, foreign exchange office) are young and talented personnel. Generational shift of officers is developed step by step.

What we should consider most in risk management of investment in PRC is to understand PRC legal framework and recognize the difference in system with Japan, US and Europe as well as to recognize administrative risk of operation different from the system. Ultimately, we should value potential and practical risk of investment in PRC in more objective manner and create proper and legal planning.

Specifically, in the field of PRC tax risk management, it is important to grasp the characteristics of PRC tax regime. What we should note is that PRC tax regime is characterized as “disregarding taxpayer interest”. One of the characteristics of PRC regime is an “excessive penalty”. Under the current tax collection administration law, additional tax rate ranges from 50% to 500%, and interest is 18.25% annually (73% annually before 2002 tax reform). Under this system, the amount of additional tax in case of three previous years exceeds the amount of principal tax amount $<104.75\%=50\% + 54.75\% (=18.25\% \times 3 \text{ years})>$. Therefore, if PRC tax risk becomes realized, the effect to Japanese enterprise would be significant.

The second characteristics of PRC regime is “burden of proof of taxpayers”. Under Japanese tax system, the Japanese tax authorities “regard the taxpayers’ interest most”. Specifically, in issuing the tax correction, the reason must be stated and the burden of proof is on the side of the tax authorities. On the other hand, the burden of proof is on the side of taxpayer in PRC. This means to counter-state the argument of PRC tax authorities, justification or appropriateness of tax payment must be proved by taxpayers. This is not so easy as expected. In the past, one taxpayer has claimed the additional tax for understatement as a result of wrong guidance of PRC tax authorities. The tax authorities changed its position suddenly and requested evidence reference of wrong guidance to the taxpayer and notified that if it cannot be proved, it would levy

additional tax and interest as a penalty. Since the guidance was made orally in the past, there was no written document proving the wrong guidance and the taxpayer only avoided the imposition of penalty. In this case, the principal tax amount was tens of millions JPY and if the penalty was imposed, there would be tax burden of 100 million JPY or more at the worst case.

The third characteristics of PRC tax regime is “three-year retroactive taxation under the guidance of tax authorities”. Probably due to frequent improper guidance by PRC tax authorities, a rule enabling three-year retroactive taxation was added under 2002 amendment of tax collection administration law. Under the amendment, although the penalty is exempted, additional risk of penalty would be incurred if wrong guidance by PRC tax authorities cannot be proved. There was an actual case where tens of millions JPY understatement was pointed out by the tax official when former tax official was moved. The PRC tax authorities are not reluctant to admit the wrong guidance and would not commit the exemption of penalty. This would show significant tax risk in PRC.

As stated above, PRC tax risk heavily depends on characteristics of PRC tax regime. Therefore, as for transaction involving huge amount of money with PRC parties, careful tax planning should be sought in advance for asking advice of professional of international taxation.

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