

## Tax Risk Management and Characteristics of The PRC Tax Regime No.2

This article is the second edition in a series of articles discussing characteristics peculiar to the PRC tax regime, which we hope will be of help when administering and managing the tax risks for Japanese companies engaging business in the PRC.

In this article two issues, taxation in the event of an in-house transaction and the differences in tax treatment for the same tax case, are discussed. These issues typically explain the peculiar tax phenomenon of the separate taxation regime in the PRC. The separate tax regime in the PRC is a tax regime that was introduced in 1994, and within which tax collection is conducted separately by the national tax office and the local tax office. In addition, further taxes are classified, according to the tax item and the taxpayer, into central revenue, local revenue and common revenue. The purpose of the separate tax regime is to eliminate the deficit of national tax revenue caused by the fact that local government spends the national tax revenue to cover its own expenses, instead of sending these funds to the national tax authorities. The national tax authorities allow local governments to collect and use a part of such major taxes, and in return request that the local government pays the other part of these national taxes to the central government.

The classification of taxes is as follows:

Tax authorities	National tax authorities		Local tax authorities
Revenue sources	National tax	Common Tax	Local Tax
Income tax	Foreign affiliated corporate income tax Corporate income tax		Individual income tax
Distribution tax	Consumption tax Customs duty	Value added tax (on goods) (75% for national tax, 25% for local tax)	Business tax (for the provision of services)

Let us now examine the issue of “tax imposition in the event of an in-house transaction”. Due to the fact that the tax allocation ratio of the common tax is 75% national tax and 25% local tax, in

cases where a plant and an office are located in different areas, the allocation ratio for the local government will differ depending on which local tax authority collects the value added tax. Specifically, if the value added tax is collected at the office where the sale of goods is conducted, and this tax collected becomes the revenue of the local tax office where the sales office is located, the local government where the plant is located is not able to secure the said tax revenue even though the plant makes the most significant gain in terms of the value of the goods. In order to secure the value added tax allocation, the local government where the plant is located will then impose the tax at the time of the shipment of the goods when the goods are moved to another area. This is the case even if the goods are moved within the company from the plant to the sales office in an in-house transaction. As the goods have not yet been sold, the tax will be calculated based on the cost of sales. Unlike the Japanese consumption tax, the value added tax has no tax refund system except for in the case of export, and the portion of the amount of purchase of goods exceeding the value added tax for sales will be adjusted in the subsequent tax year. If the goods purchased are stored in the sales office as inventory that is not sold, there is a tax risk in that the value added tax on the purchase is not eligible for the taxable purchase credit.

There is also the issue of “differences in tax treatment for the same tax case”. In the PRC, where the establishment of a sales subsidiary and a branch is restricted, the liaison office acts as a support center when receiving orders and importing, and offers after services. This liaison office is utilized extensively. The PRC tax authorities treat the activities that are conducted by the liaison office as taxable activities (activities similar to operation activities other than auxiliary or preparatory activities that are non-taxable) and impose foreign affiliated corporate income tax and business tax. The logical ground for the imposition of the foreign affiliated corporate income tax is that the liaison office is the permanent establishment (PE) in the PRC, while the business tax is imposed due to the fact that services are provided by the liaison office to the head office and affiliated companies within the PRC. Despite the fact that the tax imposition on the liaison office is prescribed under the common tax directive, there occur some cases where a liaison office that was originally treated as a non-taxable entity by the national tax authorities has been regarded as a taxable entity by the local tax office, and as a result local tax is imposed on the said liaison office.

There is also the similar case whereby the foreign affiliated corporate income tax is imposed on the liaison office that is conducting long-term technology guidance for the PRC subsidiary as a PE, while the local tax authorities do not impose the individual income tax (non-taxable). In such cases, the local tax authorities cancel the non-taxable treatment and insist on the collection of not only the individual income tax but also a penalty tax.

The above confusion is caused by the fact that the collection of major taxes is administered by different tax authorities, as well as that the local tax authorities are particularly determined to secure their tax revenues. In conclusion, it is extremely important to recognize the PRC tax regime as being totally different from the Japanese tax regime, and to take the consequent necessary measures by taking into account the PRC potential tax risk from the perspective of tax risk management.

© 2006 PricewaterhouseCoopers. All rights reserved. "PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

For further information, please contact Yasuko Takahashi or Mayumi Nakamura at:

E-mail: [pwcjapan.taxpr@jp.pwc.com](mailto:pwcjapan.taxpr@jp.pwc.com) Tel:03-5251-2400