

## China Tax News

### Special Tax Investigations in China 2012

#### Key Topics

- Special tax investigation all over China in preparation and execution
- Period: March – October 2012
- Followed by the Notification issued by the SAT, various provincial level and city level tax authorities issued implementation rules in order to execute the tax investigation, targeting different industries and sizes of companies
- Prepare for a potential tax investigation

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#### 1.) Notification on Tax Investigations

On February 21<sup>st</sup>, 2012, the State Administration of Taxation (“SAT”) issued Guo Shui Fa 2012 No. 17, “Notification on Launching the Specific Tax Investigation in 2012” (“Notification”). The Notification stipulates that starting from March and ending in October 2012, a specific tax investigation will be launched all around China.

The tax investigation will put the major focus on the following items:

- Specific tax investigation for industries



➤ Mandatory inspection

In the following situations and cases, a tax investigation shall be conducted by each province and city around China:

- For enterprises which receive special tax invoices for petroleum products;
- For capital transaction projects;
- For enterprises which are conducting exportation of VAT refundable (exemption) electronic products, clothes and furniture.

➤ Inspection examples for reference

The following items as listed in the Notice shall be references of typical tax investigation cases:

- Real estate and Construction industry;
- Local commercial banks and joint-equity banks;
- Non-resident enterprises in financial services;
- Companies withholding Individual Income Tax ("IIT") for high income earners;
- Other industries per local definition.

• Regional tax investigation

According to the Notification, each local tax authority shall conduct the tax investigation in districts where the tax management is comparatively intransparent and where a higher probability of tax avoidance would be expected. Also, special attention shall be paid to districts where agriculture products processing enterprises are centralized.

• Tax investigation for certain companies

SAT named 14 large enterprises (there are 14 large-scale state-owned enterprises and foreign investment enterprises listed as key source enterprises for inspection, covering the steel and iron, transportation, petroleum, coal, automotive and home care chemical industries) which are major sources of tax revenue and should be investigated by relevant in charge tax authorities.

## 2.) Scope and special focus of tax investigation

In addition to enterprises which receive special tax invoices for petroleum products, we noticed that the SAT's major emphasis for the tax investigation lies in the fields of:

- Capital transaction projects including industrial investment, seeking financing by listed companies, rebuilding corporate business internally, Mergers & Acquisition (“M&A”) etc.

Specifically, the SAT instructs to focus the investigation on the following items:

- Revenue
  - a) Whether all relevant revenue in cash form or non-cash form has been recorded;
  - b) Whether rental income has been recognized according to relevant prescriptions; and
  - c) Whether the Corporate Income Tax (“CIT”) for an investment via trust companies has been filed through the trust company.

- Deduction items
  - a) Whether or not tax deductible cost, expense, tax, losses etc. incurred in the current period have actual relevance with the revenue and are reasonable.
  - b) Whether there are occasions that the expenses have been over recorded;
  - c) The tax treatment of relevant assets shall be especially inspected;
  - d) The legality of the vouchers acquired shall be especially inspected.

- M&A projects

For each restructuring project, the SAT will especially inspect the transfer value, income recognition and relevant procedures.

- Appreciation and depreciation during the period of holding
- Foreign tax credit for investments overseas

By determining the nature of the enterprise as well as the relevant investment, the tax authority will check whether the foreign tax credit is correct.

- Enterprises which are conducting exportation of VAT refundable (exemption) electronic products, clothes and furniture

In particular, there are variable key points of such investigation for different kinds of enterprises in relation to the electronic products, clothes and furniture:

- For international trading companies, special attention shall be paid to the following criteria:

- a) Whether there are illegal export declarations under certain arrangements with import/export agents;
  - b) Whether there are repeated export declarations;
  - c) Whether tax has been paid for deemed domestic sales.
- For enterprises who export self-produced products:
- a) Accuracy of taxable exportation revenue;
  - b) Accuracy of transportation expense, insurance and commission expense;
  - c) Accuracy of imported bonded material record;
  - d) HS Code classification of exported products;
  - e) Whether or not the declaration of VAT exempt, credit and refund is accurate for purchased goods;
- For a producer who is a supplier of international trading companies focusing on exports:
- a) Whether the investigated entity has relevant production capability of the sales of goods;
  - b) Whether relevant expenses have actually been incurred;
  - c) Whether there are input VAT invoices for tax exempted goods such as cottons etc.;
  - d) Whether there is manufacturing outsourcing.
- In addition, if a company`s last tax audit has been conducted more than 3 years ago, the risk of being investigated within the special tax investigation 2012 may be higher.

### 3.) Status in various provinces/cities

Following the Notification issued by the state government, certain provinces and cities, based on their specific situation, have already issued some local implementation rules with special focus:

- Suzhou

Suzhou issued a local implementation notice paying additional attention to the tobacco industry, non-resident enterprises and housing leasing enterprises.

- Zhejiang

Mandatory inspection industries of Zhejiang include production and commercial enterprises which have not been inspected for years. In addition, medical institutions, adver-

tisement blasting units, hotels, design service providers, evaluation and consulting agents and the catering industry and education and training industry are included in the instruction inspection of Zhejiang.

- Hainan

In addition to the SAT Notification, the Hainan tax authorities put special importance on the advertisement and communications and transportation industry.

#### 4.) Conclusion

According to the Notification, the specific tax investigation shall last from March to October 2012. We therefore recommend enterprises to conduct the following steps as soon as possible:

- ✓ Make an internal assessment to determine if a tax investigation will be conducted according to the company`s business model.
- ✓ Keep sufficient communication with the in charge tax bureaus to comply with local requirements.
- ✓ Conduct an internal tax health check as soon as possible in order to identify possible tax exposures and risks.
- ✓ Prepare good documentation in order to mitigate the risks and in order to be ready for challenges of the in charge tax authority.

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