The Tax Regime for New Companies in China

- New companies need to consider tax compliance and tax structuring matters from the moment they set up their business in China
- Employees will be subject to individual income tax (IIT), and employers shall withhold IIT for the employees
- Furthermore, if foreign investors invest in the PRC real estate market, among other taxes, land appreciation tax (LAT) is a very important type of tax for real estate related transactions

We here discuss the main types of taxes under the PRC tax regime that new companies shall consider when setting up a business in China and highlights tax impacts on foreign investors for dividends distribution, interest payment and transfer pricing.

New companies need to consider tax compliance and tax planning matters from the moment they set up their business in China and it is necessary to understand the specific types of taxes and related tax rates for such purposes.

In China, taxes and charges apply to different types of businesses, which mainly include enterprise income tax (EIT), value-added tax (VAT), consumption tax, urban maintenance and construction tax (UMCT), education surcharge (ES), local education surcharge (LES), customs duty, deed tax, land use tax, property tax, land appreciation tax (LAT), stamp duty, etc. In addition, employees will be subject to individual income tax (IIT), and employers shall withhold IIT for the employees.

Usually, the main types of taxes and corresponding tax rates for an enterprise in China generally include the following:

Tax types	**Tax rates and related notes**

VAT	■ For general VAT taxpayers: ✓ 13% (for import and sales of goods, and provision of certain services); ✓ 9% (for import and sale of certain goods, such as agricultural goods, natural gas and etc., provision of certain services, and transfer and rental of real estate); ✓ 6% (for provision of relevant services); ✓ 5% (may apply to sale and rental of real estate as obtained/ built on/before April 30 of 2016); ✓ 3% (may apply to certain construction services and certain other services); or ✓ 0% (for export of goods and services). ■ For small-scale VAT taxpayers (for import of goods, the rates are the same as that for general VAT taxpayers): ✓ 5% (for sale and rental of real estate); ✓ 3% (for sale of goods and provision of services); or ✓ 0% (for export of goods and services).
EIT	■ Generally, 25%; ■ Small enterprise may apply a preferential tax rate at 20%, with a lower tax base until the year end of 2022; ■ A PRC entity shall pay EIT for its global income.
UMCT	■ 7% (for city area); ■ 5% (for the town area smaller than a city); or ■ 1% (for other areas); ■ Generally calculated based on the VAT payable amount (excluding the importation VAT amount).
ES	■ 3%, tax basis is the same as that of UMCT.
LES	■ 2%, tax basis is the same as that of UMCT.
Stamp Duty	■ For dutiable contracts (for example): ✓ 0.03% (purchase and sales contracts), ✓ 0.05% (transfer of shares of non-listed company), or ✓ 0.1% (warehousing contracts and rental contracts), ✓ Each party of the signers shall pay such Stamp Duty. ■ For the accounting book recording the received capital and capital reserve: ✓ 0.025%, ✓ The company receiving the capital shall pay such Stamp Duty.
Customs Duty (importation)	■ Depending on the specific types of goods imported, For example, for certain products, the most-favored nation tax rate is 10%, while the general tax rate is 40%.

IIT on salary income	▪ 3% - 45%

Furthermore, if foreign investors invest in the real estate market, LAT is a very important type of tax for real estate related transactions. For enterprises transferring real estates, applicable LAT rates range from 30% to 60%, subject to exemptions or reductions upon satisfying certain criteria.

If investors of a PRC company are foreign entities, they need to consider the tax impact of: (1) dividends distribution; (2) interest payment; and (3) transfer pricing of the purchase and sales. The tax impacts of them are discussed in more detail in the following section.

1. Tax impacts of dividends distribution

Generally, the dividends paid by a PRC company to foreign entities shall be subject to PRC EIT at a rate of 10% according to PRC domestic rules. Certain tax treaties with specific jurisdictions provide preferential EIT rates for the dividends. A PRC company shall withhold EIT for the dividends.

2. Tax impacts of interest payment under shareholders' loans

Generally, the interests paid by a PRC company to foreign entities will be subject to PRC EIT at a rate of 10% (tax treaties may provide lower rates), as well as VAT (6%) and surcharges. It is worth noting that starting from 1 September 2021, surcharges (including UMCT, ES and LES, at a maximum total rate of 12% of the actually paid VAT amount) are exempted for foreign service providers (including entities providing loan services to a PRC company). A PRC company shall withhold EIT and VAT for the parent company for the interest income under shareholders' loans.

The PRC EIT tax rules require the expenditure (such as interest expense) incurred by a PRC company be distinguished between income related expenditure and capital related expenditure. Among them, the income related expenditure could be directly deducted in the current period for EIT purposes, while the capital related expenditure should be deducted in installments or included in the cost of relevant investment assets and may not be directly deducted (fully) in the current period for EIT purposes.

In addition, the deduction of interest expense for EIT purposes for a PRC company is also subject to certain restrictions: (a) the pricing of the interest rate of the shareholders' loan should be in line with the arm's length principle; (b) the proportion of "debt investment amount vs. equity investment amount" of the parent company into the PRC company usually shall not exceed 2:1 (Thin Capital Rules); (c) the interest expense shall not exceed the amount as calculated according to the corresponding loan interest rate of relevant financial institutions in the same interest-calculating period; and (d) where the parent company fails to pay up their due capital contribution to the PRC company within the specified time limit (if any), a part of the interest expenses incurred by the PRC company that is equivalent to the interest amount accrued as if for the outstanding capital receivable amount may not be deducted by the PRC company when calculating its EIT taxable income.

3. Tax impacts of transfer pricing

The pricing of the purchase and sales of goods and services between related parties should be in line with the arm's length principle. Otherwise, tax authorities may make adjustments. To justify the transfer pricing rationale, a benchmark study may be necessary.