Baker McKenzie.

Legal Update

May 2023

China: Tax Update | May 2023

In brief

In this issue of China Tax Update, we will discuss the major China tax developments in the first four months of 2023, including the following:

1. New functions launched in E-tax system nationwide for non-resident enterprises to register for tax and make filings for domestic equity transfers
2. Up-scale of super deduction ratio for R&D expenses
3. Tax-related proposals at the 14th National People's Congress and their implementation

Contents

1. New functions launched in E-tax system nationwide for non-resident enterprises to register for tax and make filings for domestic equity transfers

In brief

China's State Taxation Administration (STA) has launched a cross-border tax service for non-resident enterprises in April 2023, by adding a functional module in the nationwide online tax filing system, i.e., E-tax China, through which overseas enterprises can directly register for tax, make filings and attend to settlement online for domestic equity transfers.

In detail

"Non-resident enterprise" refers to an enterprise which is established and actually managed in a jurisdiction other than China, either having an office or premises established in China, or having income derived from China but with no office or premises therein. The new function supports both Chinese and English and is specifically applicable to non-resident enterprises which obtain equity transfer income from non-listed companies (not including restricted shares) in China with no withholding agents and need to file enterprise income tax ("**EIT**") and stamp duty per occurrence on their own. The E-tax system provides services such as contract information collection, intelligent judgment of tax obligations, tax calculation, and cross-border tax payment.

With the launch of the new functions in E-tax system, non-resident enterprises can register for tax using a valid E-mail address[1] and then upload certificates for verification. After verification, they will obtain their unique taxpayer identification numbers, which enable them to register, declare and pay taxes online with nationwide applicability.

It is reported that this service is the first of its kind in the country, and is a timely and effective response to enormous needs for cross-border tax service.

[1] Individuals who reside overseas used to have trouble registering through the E-tax bureau because they do not have a Chinese mobile phone number and cannot receive SMS to authenticate their personal ID. Now non-resident individuals are permitted to register via their E-mails, which is a breakthrough and good news for them.

Our observation

China has been optimizing its business environment for international taxation and trying to remove barriers for cross-border tax payment. The new functions launched in the E-tax system should save overseas taxpayers from the burden of on-site visits and tax filings to some extent. However, proactive communications with the in-charge tax authority beforehand are still inevitable because of the following reasons:

- To our best knowledge, though tax filings can be submitted in the E-tax system, it is still necessary for foreign taxpayers to discuss with the tax authority the pathways to make cross-border tax payments unless the taxpayer can use UnionPay for tax settlement.[2]
- Although the pre-filing review and approval by the tax authority are not legally required under the current regime, given the immaturity of online tax payment function and our previous tax filing experience, it is still important to communicate with the tax authority beforehand and to reach a consensus on the pertinent matters to secure tax certainty for the overseas taxpayers, such as the reasonableness of the equity transfer price and the tax basis therein.

It is also important to note that E-filing is not applicable if the taxpayer wishes to claim the special tax treatment granted to overseas taxpayers under the STA Bulletin [2013] No. 72,[3] or if the taxpayer would like to claim tax treaty benefits under the applicable tax treaty/arrangement signed by China with the taxpayer's resident jurisdiction. Accordingly, it is still necessary for taxpayers with such needs to make on-site visits to the in-charge tax authority.

2. Up-scale of super deduction ratio for R&D expenses

In brief

As an ongoing policy to encourage R&D activities by enterprises, the PRC EIT Law and its Implementation Regulations allow enterprise taxpayers to claim a super-deduction for expenses actually incurred in R&D activities when calculating taxable income for EIT purpose. Effective from 1 January 2023, the 100% super-deduction ratio for R&D expenses formally replaced the previous ratio of 75% and will be continued for a long term with no specific expiration date yet. As such, if the R&D expenses do not form intangible assets and are included in the current profits and losses, on the basis of actual deduction, an additional 100% of such R&D expenses can be deducted for the calculation of taxable income; if the R&D expenses have formed intangible assets, they can be amortized at 200% of the actual cost of intangible assets for taxation purposes.

In detail

1) Development of R&D super-deduction policy

The super-deduction incentive for an enterprise's R&D investment was firstly stipulated by the lawmakers in the enacted PRC EIT Law in 2008.[4] The super-deduction ratio of R&D expenses was 50% then in default.

In 2015, the state significantly expanded the scope of qualified R&D activities and expenses, and clarified the negative list regime for the first time,[5] where only enterprises engaging in the industries specified in the negative list are disallowed to claim the super-deduction of R&D expenses for taxation purpose.[6]

---

[2] UnionPay is China's sole bankcard association and the equivalent of Visa and Mastercard in the United States.

[3] The Notice of the STA on Issues concerning the Special Tax Treatment Applicable to Equity Transfers by Non-resident Enterprises, STA Bulletin [2013] No. 72, dated 12 December 2013 and effective from the same date.

[4] See Article 30 of the PRC EIT Law and Article 95 of the Implementation Regulations of the PRC EIT Law.

[5] The Notice on Improving the Policy on the Pre-tax Additional Deduction for R&D Expenses, Caishui [2015] No. 119, dated 2 November 2015 and effective from 1 January 2016.

[6] The industries specified in the negative list include: (1) tobacco manufacturing; (2) lodging and catering; (3) wholesale and retail; (4) real estate development; (5) leasing and other commercial services; (6) entertainment; and (7) other industries to be specified by the Ministry of Finance (MOF) and STA.

In 2017, the state increased the super-deduction ratio for technology-based small and medium-sized enterprises ("**TSME**") from 50% to 75%.[7]

In 2018, the state raised the super-deduction ratio for enterprises in all eligible industries from 50% to 75%,[8] and allowed commissioned overseas R&D expenses to be deducted before tax.[9]

In 2021, the state, for the first time, increased the super-deduction ratio for manufacturing enterprises from 75% to 100%,[10] and allowed enterprises to claim super-deductions for R&D expenses incurred in the first three quarters during the filing period in October every year.[11]

In 2022, the super-deduction ratio for TSMEs was also increased from 75% to 100% as a means of encouraging innovation.[12] Then on 22 September 2022, the government temporarily elevated the super-deduction ratio for other eligible enterprises from 75% to 100% during the period from 1 October 2022 to 31 December 2022.[13]

On the basis of the above, the government released the Bulletin [2023] No. 7 ("**Bulletin 7**") in March 2023,[14] consolidating the previously scattered incentives for different types of enterprises and uniformly stipulating the 100% super-deduction ratio for all eligible industry enterprises as a long-term policy for implementation. Nowadays and going forward, all eligible enterprises are entitled to:

- Claim an additional 100% deduction on eligible R&D expenses actually incurred for EIT purposes; or
- Amortize the intangible assets based on 200% of the actual costs incurred, if the incurred R&D expenses have been capitalized.

2) Administrative requirements

Following the release of the new policy increasing the super-deduction ratio for R&D expenses from 75% to 100%, the STA published an updated summary of currently effective implementation policies at the end of March, which includes the administrative requirements such as the applicable scope of taxpayers, eligible R&D activities,[15] deductible expenditures as well as relevant accounting requirements.

a) Auxiliary accounts

As required, the taxpayers shall establish auxiliary accounts for R&D expenses when the R&D projects are set up. The actual amount of R&D expenses that can be super-deducted in the current year shall be accurately aggregated and accounted for.

---

[7] The Notice on Increasing the Ratio of the Pre-tax Additional Deduction for R&D Expenses for Technology-based Small and Medium--sized Enterprises, Caishui [2017] No. 34, dated 2 May 2017 and effective from the same date.

[8] The Notice on Raising the Pre-tax Super Deduction Ratio of R&D Expenses, Caishui [2018] No. 99, dated 20 September 2018 and effective from the same date.

[9] The Notice on Relevant Policies for the Pre-tax Super Deduction of Expenses for Overseas R&D Activities Commissioned by Enterprises, Caishui [2018] No. 64, dated 25 June 2018 and retrospectively effective from 1 January 2018.

[10] The Notice on Further Improving the Policy on Pre-tax Super Deduction of R&D Expenses, MOF and STA Bulletin [2021] No. 13, dated 31 March 2021 and retrospectively effective from 1 January 2021.

[11] The Notice of the STA on Relevant Issues concerning Further Implementing the Policy on Pre-tax Super Deduction of R&D Expenses, STA Bulletin [2021] No. 28, dated 13 September 2021 and effective from the same date.

[12] The Notice on Further Increasing the Pre-tax Additional Deduction Ratio of R&D Expenses for Technology-based Small and Medium-sized Enterprises, Bulletin [2022] No. 16, dated 23 March 2022 and retrospectively effective from 1 January 2022.

[13] The Notice of Increasing Pre-tax Deduction for Supporting Scientific and Technology Innovation, Bulletin [2022] No. 28, dated 22 September 2022 and effective from the same date.

[14] The Notice of MOF and STA on Further Improving the Policy on Pre-tax Super Deduction of R&D Expenses, Bulletin [2023] No. 7, dated 26 March 2023 and retrospectively effective from 1 January 2023.

[15] Eligible R&D activities refer to processes where an enterprise applies new science and technology knowledge creatively for the purpose of obtaining new science and technology knowledge or carrying out systematic activities with specific goals continuously for substantive improvement of technologies, products (services), and processes. Non-creative activities, such as conventional upgrades of the enterprise's products, are not regarded as eligible for the R&D super deduction policy.

The company will need to maintain the relevant records for later audit, if any. The tax authority released two versions of auxiliary account style in 2015 and 2021 respectively, and enterprises can set up their auxiliary accounts by reference to the exemplary auxiliary account styles or design their own auxiliary account style for R&D expenses.

b) Contract R&D arrangement

For expenses incurred in R&D activities entrusted by enterprises to external organizations or personnel within China, 80% of the actual amount shall be included in the entrusting party's R&D expenses and allowed for the additional deduction.

For expenses incurred in R&D activities entrusted by enterprises to external organizations (excluding personnel) outside of China, 80% of the actual expenses shall be itemized as the entrusting party's commissioned overseas R&D expenses. To the extent of two-thirds of the entrusting party's qualified domestic R&D expenses, the entrusting party is allowed to claim such overseas R&D expenses for pre-tax super deduction purposes.

c) Filing requirements

Similar to other EIT preferential policies, there is no longer a prior filing or approval requirement for the benefit of super deduction for R&D expenses. Enterprise taxpayers can enjoy the incentive when making tax payments (at the time of pre-payment or annual settlement) by self-evaluating if they are qualified and retaining relevant documents for future audit by tax authorities, if any.

It is important to note that R&D activities entrusted to overseas organizations are subject to particular documentation requirements. Upon request by the tax authority, the party that commissioned overseas R&D activities should provide the following materials for verification:

- The business proposal for the enterprise's commissioned R&D project and the resolution made by the enterprise's competent department to set up the project;
- The constitution of the specialized institution or project team undertaking the commissioned R&D activities, and the list of R&D personnel;
- The contract for commissioned overseas R&D activities that has been registered with the administrative department of science and technology;
- Auxiliary accounts and the summary sheet for R&D expenses;
- Bank payment documents for commissioned overseas R&D activities, and receipt vouchers issued by the commissioned party; and
- The progress of the commissioned R&D project in the current year, etc.[16]

Our observation

In recent years, the state has repeatedly upgraded the super-deduction ratio of R&D expenses and played a rather positive role in supporting enterprises to increase their R&D investment, which demonstrates the Chinese government's eagerness to support tech innovation in face of a more complex geopolitical environment.

The updated super-deduction policy for R&D expenses have the following benefits:

- The executive meeting of the State Council made it clear that the 100% super-deduction ratio of R&D expenses for eligible enterprises will be implemented as a long-term policy, which provides enterprises with a much clearer expectation and is conducive to enterprises arranging their R&D activities and corresponding capital investment in a more efficient way.
- Prior to the release of Bulletin 7, manufacturing enterprises, TSMEs, and other enterprises were subject to different super-deduction policies for R&D expenses. Now pursuant to Bulletin 7, all types of enterprises are uniformly subject to the same policy and thus relieved from undue administrative burdens.

[16] Where an enterprise has obtained the authoritative opinions issued by the administrative department of science and technology on the assessment of the concerned R&D activities, it shall retain such opinions as materials for future reference as well.

- From the tax compliance perspective, enterprises should establish an effective internal management account for the documentation and aggregation of R&D expenses. The tax authority will likely resort to post-filing supervisions to monitor the taxpayer's claims for super deductions of R&D expenses.

3. Tax-related proposals at the 14th National People's Congress and their implementation

In brief

At its first session on 13 March 2023, the 14th National People's Congress approved the National Economic and Social Development Plan of Year 2023 ("**2023 Plan**"), deciding to extend or optimize the existing tax and fee cut policies. Further to the 2023 Plan, at an executive State Council meeting chaired by the newly nominated Premier Li Qiang on 24 March 2023, China's State Council announced the extension or renewal of a range of supportive tax and fee cut policies. According to the government's estimation, those policies are expected to reduce the annual tax and fee burden on eligible companies by more than RMB 480 billion. Following the executive State Council meeting, the relevant governmental departments have released the official policies for implementing the tax-related proposals.

In detail

The highlights of the pertinent tax policies are discussed as follows:

1. Up-scale of super-deduction ratio for R&D expenses

As discussed in Section 2, to further encourage the enterprises' investment into R&D activities and better support sci-tech innovation, the existing pre-tax additional deduction ratio of R&D expenses for eligible companies has been elevated from 75% to 100%. Additionally, the newly introduced policy will be implemented as a long-term incentive scheme with no expiration date specified. For more detailed descriptions on the development of such policy and its implementation rules, please refer to Section 2 above.

2. Extension and adjustment on income tax cuts for small and low-profit enterprises and sole proprietorships

The authority has extended and adjusted the preferential income tax policies for small and low-profit enterprises ("**SLPEs**").[17] For the period from 1 January 2023 to 31 December 2024, qualifying SLPEs and sole proprietorships are entitled to the following income tax preferences.[18]

- Qualifying SLPEs: eligible to be taxed on just 25% of their taxable income at a reduced income tax rate of 20% for the part of taxable income not exceeding RMB 1 million, i.e., the effective tax rate is 5% for the taxable income not exceeding RMB 1 million. For completeness, the portion of SLPEs' annual taxable income over RMB 1 million but not exceeding RMB 3 million is subject to the same effective tax rate (i.e., 5%) as well for the period from 1 January 2022 to 31 December 2024.[19]
- Sole proprietorships: eligible to 50% reduction of their individual income tax payable for the portion of taxable income not exceeding RMB 1 million, while other prevailing preferential policies granted to sole-proprietorships remain valid and applicable still.

3. Extension of the zero-tariff policy for coal imports

[17] Qualifying SLPEs refer to those engaged in non-restricted and non-prohibited industries and concurrently meet the following criteria: (1) annual taxable income does not exceed RMB 3 million; (2) number of employees does not exceed 300 people; and (3) total assets do not exceed RMB 50 million.

[18] The Notice of MOF and STA on the Preferential Income Tax Policy for Small and Low-profit Enterprises and Sole Proprietorships, Bulletin [2023] No. 6, dated 26 March 2023 and effective from 1 January 2023 to 31 December 2024.

[19] The Notice of MOF and STA on Further Implementing the Preferential Income Tax Policy for Small and Low-profit Enterprises, Bulletin [2022] No. 13, dated 14 March 2022 and retrospectively effective from 1 January 2022.

The provisional zero-tariff policy for the importation of coal has been further extended by the Customs Tariff Commission of the State Council.[20] Such policy was to expire on 31 March 2023 and is now extended to 31 December 2023. The zero-tariff policy for coal importations was first introduced in April 2022 to strengthen the security of energy supply in response to the overseas inflation of coal prices.

4. Extension of the incentive policy of urban land use tax for logistics enterprises

For logistic enterprises, the policy of half-reduced urban land use tax on land used for qualifying bulk commodity storage facilities, which was introduced to promote the development of logistic industry and initially set to expire at the end of 2022, will be extended to the end of 2027.[21]

Our observation

In comparison with the tax and fee cut policies implemented by China's government in 2022, the scale and amount of the renewed or extended preferential tax policies that have been implemented so far are considerably smaller. This is partially because the COVID-19 pandemic has ended and China's economic development is back on the normal track. The government is no longer as eager to revive the macroeconomy by providing full-fledged impetus to the market as it was in 2022.

Meanwhile, China's government, especially the ones at the local level, is under strained budgets as they have put in tremendous resources for epidemic controls while the fiscal revenue growth has slumped as a result of the slowing economy in preceding years. It is not financially workable for the government to continue large-scale tax and fee cuts in the long term.

It is anticipated that the government will still provide impetus and support for key industries and certain types of business entities where necessary and possible for economy recovery. However, it is not likely that another round of large-scale tax reduction as what we witnessed in the last year will be reproduced.

At the same time, to ease the fiscal pressure on local governments, the tax authority will likely strengthen the daily supervision of the tax compliance status of taxpayers in key industries with relatively high risk exposures. Taxpayers, including multinational companies, should be mindful of their business arrangements that may incur potential tax risks and get prepared in advance for any inquiries from the tax authority or even tax investigations on critical issues of concern, such as transfer pricing policies, permanent establishment implications, tax treaty benefits, pre-tax deduction matters, etc.

[20] The Notice on Extending the Implementation Period of the Provisional Zero-tariff Policy for Coal Imports, Customs Tariff Commission Bulletin [2023] No. 3, dated 24 March 2023 and effective from 1 April 2023 to 31 December 2023.

[21] The Notice of MOF and STA on Renewing the Preferential Urban Land Use Tax Policy on Land Used by Logistics Enterprises for Bulk Commodity Storage Facilities, Bulletin [2023] No. 5, dated 26 March 2023 and effective from 1 January 2023 to 31 December 2027.

Contact Us

Jason Wen
Beijing
jason.wen@bakermckenziefenxun.com

Abe Zhao
Beijing
abe.zhao@bakermckenziefenxun.com

Jinghua Liu
Beijing
jinghua.liu@bakermckenziefenxun.com

Brendan Kelly
Shanghai
brendan.kelly@bakermckenzie.com

Nancy Lai
Shanghai
nancy.lai@bakermckenzie.com

Luis Zhang
Shanghai
luis.zhang@bakermckenziefenxun.com

Amy Ling
Hong Kong
amy.ling@bakermckenzie.com

Shanwu Yuan
New York
shanwu.yuan@bakermckenzie.com