

taxtalk

newsletter

Grant Thornton 
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This summer, the “black signal” hot weather warning has been hoisted in major cities all over China as heat waves continue to swamp the country. Temperatures hitting as high as 38 degrees Celsius linger around the middle and lower reaches of the Yangtze River, as well as in the southern Pearl River Delta region.

As the number of high-temperature days outnumbers the officials’ predictions, homes, offices and factories turn up their air-conditioners to beat the heat. This has put additional strain on China’s power shortfall. To cope with the energy shortage, Chinese officials have issued policies and regulations to conserve energy and ration power supply. Shanghai’s Municipal officials have ordered buildings alongside the famous Shanghai Bund to turn off their spectacular lights at night. Companies are ordered to shift working hours to the evening. Factories have to halt production for as many as several days every week.

Despite the austerity measures taken by the Chinese Government and the cutback in factory outputs, the economy of China, in particular in the Yangtze and Pearl River Deltas, continues to be “hot” and has soared to an all-time high since China became a member of the World Trade Organisation (WTO) on 11 December 2001. Foreign direct investments (FDI) into China have grown rapidly in recent years. According to recent statistics released by the Chinese government, in the

first 6 months of 2004, newly approved foreign investment enterprises reached a total of 21,688, representing a 15% growth as compared with the first half of 2003. Contracted foreign investment reached USD72.7 billion, and the actual use of foreign investment reached USD33.9 billion, representing 43% and 12% growth respectively as compared with the same period last year.

Market access to various business sectors on the Chinese Mainland has, since the accession to the WTO, gradually been made available to foreign investors to a much wider extent. Tariffs have been reduced; technical and administrative barriers to trade are being removed. Rules and regulations are now being published on Chinese government websites to provide a more transparent, predictable and non-discriminatory trading environment for locals and foreign investors alike. The surge of foreign investment into China has sped up the need for China to reform its government administration as it busily transforms itself from a planned economy into a market economy system.

China has promised to open its import and export trading and its retail and distribution markets to foreigners within a 3-year period that will be reached by the end of 2004. In order to honour its WTO commitments, China has undertaken the most formidable task of revising, revamping and reforming its laws and regulations. Significant legislative



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Customs valuation – an evolving process

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amendments made recently include:

The revised foreign trade law which became effective on 1 July 2004. It allows an individual to engage in international commerce for the first time. Import and export trading rights on cargo and technology are granted to organisations as well as individuals by a process of registration instead of licensing. The revised law also contains new contents on the protection of intellectual property rights in relation to foreign trade, foreign trade discipline, investigation, and legal liabilities against violations.

The administrative measures for foreign investment in the commercial sector were effected on 1 June 2004. They remove most of the barriers for foreign investors to access the Chinese domestic wholesale and retail markets starting from 11 December 2004. They also reduce the registered capital requirements, expand the scope of commercial activities to include commission agency and franchising, and delegate the approval authority from the state to the provincial level under certain circumstances.

The decision by the state council to reform the investment system was announced on 28 July 2004. The administration and approval processes for both Chinese and foreign investment projects will be simplified. The approval authority for foreign investment projects will be further delegated to the provincial level. The approval limit at the provincial level for

encouraged and permitted projects will be increased from US\$30 million to US\$100 million, and for restricted projects from US\$30 million to US\$50 million.

As China steadily refines its legislative framework, it is also slowly tightening up the enforcement of tax collection from locals as well as from foreigners who derive income from China. Noting that it may be difficult for foreigners to fulfil their tax compliance obligations in China due to their mobility and the complexity of the Chinese income-tax system, the State Administration of Taxation has approached the issue with a practical solution and provided an amnesty until 30 June 2004 for foreigners to report and settle their back-year income tax without imposing any penalties.

China is also planning for another round of income-tax reform to unify the income-tax rates for both Chinese and foreign enterprises, and afford all the same national treatment. According to unofficial sources, the new unified corporate income-tax rate will be around 25% to 30%. It is believed that the draft new corporate income-tax law will be reviewed by relevant departments of the State Council in August 2004, submitted to the National People's Congress for examination and approval in March 2005, and officially implemented in 2006. There will be a short transition period to phase in the new law. It is envisaged that tax incentives will be granted by industrial considerations instead of regional preferences.

Changes in valuation methods

Before China's accession to WTO, the Chinese Customs used to adopt a so-called "the lowest valuation" method in determining the dutiable value of goods imported into China. This method has been adopted since 1988.

Imported goods declared at a value above "the lowest valuation" would normally be accepted by the Chinese Customs. This method was later referred to as the "reference pricing method" and has been applied for many years notwithstanding that the method was not in line with the WTO customs valuation agreement.

China has agreed to abide by the principles laid down in the agreement on its accession to WTO. The recent amendment of its customs laws and regulations was a process to conform with these principles.

In late 2003, the State Council issued an order numbered 392 to amend "The PRC Regulations on Import and Export Duties". Effective from 1 January 2004, amendments were made to areas including (i) the applicability of customs duty rates for goods imported from different countries and regions; (ii) the treatment of goods imported into China under special circumstances; (iii) changes in administrative measures; and (iv) the determination of dutiable value of imports and exports that are in accordance with the principles set down in the WTO customs valuation agreement.



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Transaction price

The amended regulations adopt transaction price for import declaration purposes. It is required to include in the dutiable value other relevant costs such as shipping and insurance, as well as any other related costs that may be incurred in bringing the imports to the point of uploading on their arrival in China.

The transaction price refers to the actual price of a transaction which the buyer and seller agree to complete independently. Any direct and indirect payments incurred for the completion of the transaction should also be included. The use of transaction price for customs declaration is supposed to make the process more efficient. However, commercial environment is always much complicated. The existence of a connected relationship between buyer and seller makes it difficult for the Chinese Customs to determine a “fair” transaction price for customs declaration purposes.

The regulations allow the Chinese Customs to adopt other methodologies in estimating the dutiable value of imports if it considers that the transaction price declared by an importer is not a fair dutiable value. The estimated value can be referenced to identical or similar imports into China at or about the same time of the imports. If these methods are not applicable, the Chinese Customs may adopt deduction or “cost plus” methods to estimate the dutiable value. However, in practice, these

methods are rarely applied as a result of the disagreement between the taxpayer and the Customs authorities in adopting comparable data.

A direct and simple method is to make reference to the price of imports in the database maintained by the Chinese Customs. This huge database relies on a continuous input of updated data by the Chinese Customs authorities in different locations. The Chinese Customs officials can make quick reference to the database for the dutiable value of imports declared by different importers at different locations. Not only this will increase efficiency in the customs declaration process, it will impel the Chinese Customs officials to be much handier in collecting information for the conduction of Customs investigation.

Position of importers

The amendment of the regulations will not release the pressure on importers. They are obliged to ensure that the dutiable value declared is a fair transaction price. This is particularly difficult for multinational companies that operate across borders whereby the buy-sell activities are conducted between related companies. Companies with business operations in China should be careful in setting their pricing policies on goods sold to related companies in China. Pricing should be referenced to transactions between unrelated parties. All relevant costs such as royalties and commission should be analysed and included in the dutiable value

for customs declaration. Omission of these costs from the dutiable value may lead to subsequent penalties and surcharges.

The pricing policy set down should be properly documented. The existence of documents can record the benchmarks adopted in setting the price of goods sold to related companies in China. Comparable data for similar or identical goods imported to other countries should be included for reference.

Setting a pricing policy is not a once-and-for-all process. Companies should review and update their pricing policies by including new and updated market information, such as changes in market conditions and seasonal factors, etc. Data from previous years accepted by the Chinese Customs can be used for reference in determining future pricing after making appropriate adjustments.

China has adopted the principles in the WTO valuation agreement in its customs regulations and has become more willing to accept the transaction price for import declaration purposes. However, the changes in regulations can never resolve all issues. The Chinese Customs will continue to bring its regulations and practice into conformity with those adopted by other countries. Importers should keep watching for, and prepare themselves to cope with these changes.

Individual income tax amnesty and latest developments



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In March 2004, the PRC's State Administration of Taxation (SAT) provided an individual income tax (IIT) amnesty with the release of Guoshuifa [2004] No. 27. The amnesty programme is geared towards foreign expatriates. It offers an opportunity for them to clean the slate relating to the past by repayment of any tax and late payment surcharges without penalties.

Unfortunately, there is no gain without pain. From a practical point of view, some expatriates are reluctant to rectify their tax position as this will require disclosure of both personal and corporate (employer) information. They are also worried about the negative impact on their future credibility from the perspective of the tax bureau. Some expatriates who owe a large amount of tax are particularly concerned about whether the tax bureau will strictly enforce the surcharge provision as this can affect their short-term cashflow position. Prior to May 2001, the surcharge was calculated at a daily rate of 0.2% on overdue tax. The daily rate was only lowered to 0.05% from 1 May 2001 onwards.

In order not to discourage expatriates from availing themselves of the opportunity to bring their tax affairs up to date, it appears that the SAT have left some of the details of the amnesty programme intentionally vague so that local tax bureaux can exercise their discretion over its implementation. For instance, the notice states that the data relating to voluntary reporting should be filed on or before 30 June 2004. It is silent on the timing of actual repayment. Some local tax officials have therefore granted an extension for repayment until 31 December 2004. A recent notice issued by the SAT has confirmed that the grant of such an extension is within the ambit of the amnesty programme.

Apart from the extension of the payment period, some taxpayers have attempted to negotiate with local tax officials for a "better deal". Some of the "negotiable" terms include a waiver or reduction of surcharge, and the number of years for which an expatriate must file. However, taxpayers should be cautioned that such deals may fall outside the scope of the amnesty

provisions and therefore taxpayers may run the risk of being penalised if and when their tax position is revisited. To dispel some common misconceptions, the SAT has recently announced that there is no provision exempting taxpayers for reporting underpaid tax that has been overdue for more than three years. In addition, although some taxpayers may persuade local tax officers to accept a partial repayment of tax in accordance with a "reasonable benchmark", they may still be exposed to penalties or enquiries in the future since the discretion exercised by the tax officers may have exceeded their authority as laid down by the law.

It is anticipated that after the end of the amnesty programme the SAT will tighten up the future administration of the collection of IIT. Taxpayers should therefore take advantage of this good but possibly final chance to regularise their tax affairs. Creative means for reducing the amount of tax repayment or surcharge should be reviewed carefully to ensure that they are not outside the scope of the law.

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