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China Tax Administration Guide (3) - Taxable Income

1. Basic Regulations

- (1) Where an enterprise with foreign investment invests in another enterprise within China, the profit (dividends) obtained from the enterprise receiving the investment may be excluded from its taxable income; however, expenses and losses incurred in the investment process may not be deducted from its taxable income. (GUO WU YUAN LING [85] 1991.6.30)
- (2) Unless otherwise stipulated by the State, the following items shall not be itemized as costs, expenses or losses in the calculation of taxable income:
 - (a) expenses connected with the acquisition or construction of fixed assets;
 - (b) expenses connected with the transfer or development of intangible assets;
 - (c) interest on capital;
 - (d) various Income Tax payments;
 - (e) fines for illegal business operations and losses due to the confiscation of property;
 - (f) surcharges and fines for overdue payment of taxes;
 - (g) that part of losses due to natural disasters or accidents for which there has been compensation;
 - (h) donations and contributions other than those used in China for public welfare or relief purposes;
 - (i) royalties paid to the head office;
 - (j) other expenses not related to production or business operations.(GUO WU YUAN LING [85] 1991.6.30)
- (3) For foreign enterprises with an establishment or site in China, reasonable administrative expenses paid to its head office in connection with production or business operations of that establishment or site, may be itemized as expenses following agreement by the local tax authorities after their examination and verification of documents issued by the enterprise's head office in respect of the scope of the administrative expenses, total amounts and the basis and methods of allocation; these documents shall be provided together with an accompanying verification report by a certified public accountant.(GUO WU YUAN LING [85] 1991.6.30)

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- (4) Reasonable interest payments incurred on loans connected to production and business operations may be itemized as expenses following agreement by the local tax authorities after their examination and verification of documents with respect to loans and expenses, which documents shall be provided by the enterprises. Interest paid on loans used by enterprises for purchasing or constructing fixed assets or transferring or developing intangible assets prior to the assets being put into use, shall be included in the original value of the assets. Reasonable interest refers to interest calculated at a rate not higher than normal commercial lending rates. (GUO WU YUAN LING [85] 1991.6.30)
- (5) Entertainment expenses incurred by enterprises in connection with their production and business operations, when supported by authentic records or invoices and vouchers, may be itemized as expenses subject to the following limitations:
- (a) Where annual net sales are 15 million yuan or less, such expenses may not exceed 0.5% of net sales; for that portion exceeding 15 million yuan, such expenses may not exceed 0.3% of that portion of net sales;
- (b) Where annual gross business income is 5 million yuan or less, such expenses may not exceed 1% of gross business income; for that portion which exceeds 5 million yuan, such expenses may not exceed 0.5% of that portion of annual gross business income.
- (GUO WU YUAN LING [85] 1991.6.30)
- (6) Exchange gains or losses incurred by enterprises during pre-construction or during production or business operations shall be appropriately itemized as gains or losses for that period, except as otherwise provided by the State. (GUO WU YUAN LING [85] 1991.6.30)
- (7) Salaries and wages, allowances and benefits paid by enterprises to their employees may be itemized as expenses following agreement by local tax authorities after their examination and verification of the submitted wage scales, supporting documents and relevant materials.
- Foreign social security premiums paid by enterprises for their employees working in China may not be itemized as expenses. (GUO WU YUAN LING [85] 1991.6.30)
- (8) Where enterprises engaged in such businesses as credit and leasing operations, if there is actual need and following approval by the local tax authorities of a relevant submitted report, such enterprises may make yearly provision for bad debts, the amount of which shall not exceed 3% of the year end loan balance (not including inter-bank loans) or the amount of accounts receivable, notes receivable and other receivables, and which may be deducted from taxable income for that year.
- The portion of bad debt losses actually incurred by an enterprise which exceeds the bad debt provisions of the preceding year, may be itemized as loss in the current

year; if the portion is less than the bad debt provisions of the previous year the balance shall be included in taxable income for the current year.

Bad debt losses; referred to in the preceding paragraph shall be subject to examination and approval by the local taxation authorities.(GUO WU YUAN LING [85] 1991.6.30)

- (9) Bad debt losses; refers to the following accounts receivable:
- (a) due to the bankruptcy of the debtor, collection is still not possible after the use of the bankruptcy assets for settlement;
 - (b) due to the death of the debtor, collection is still not possible after use of the estate for repayment;
 - (c) after the failure of the debtor to fulfill repayment obligations for over 2 years, collection is still not possible.
- (GUO WU YUAN LING [85] 1991.6.30)
- (10) Accounts receivable already itemized as a bad debt loss, but which are recovered in full or in part by an enterprise in a subsequent year, shall be included in taxable income for the year in which they were recovered.(GUO WU YUAN LING [85] 1991.6.30)
- (11) Where enterprises have establishments or sites in China, unless otherwise provided by the State, they may deduct as expenses foreign Income Tax which has been paid on profits (dividends), interest, rental income, royalties and other income received from outside China and actually connected with those establishments or sites.(GUO WU YUAN LING [85] 1991.6.30)
- (12) Net assets or remaining property; in Article 18 of the Tax Law refers to the amount remaining after various liabilities and losses have been deducted from all assets or property, when an enterprise is liquidated.(GUO WU YUAN LING [85] 1991.6.30)
- (13) The formula for the computation of taxable income is as follows:
- (a) Manufacturing:
 - a. taxable income = (profit on sales) + (profit from other operations) + (non-business income) - (non-business expenses);
 - b. profit on sales = (net sales) - (cost of products sold) - (taxes on sales) - {[selling expenses] + [administrative expenses] + [financial expenses]};
 - c. net sales = (gross sales) - {[sales returns] + sales discounts and allowances}
 - d. cost of products sold = (cost of products manufactured in the period)+(inventory of finished products at the beginning of the period) - (inventory of finished products at the end of the period);
 - e. cost of products manufactured in the period = (manufacturing costs for the period) + (inventory of semi-finished products and products in process at the

beginning of the period) - (inventory of semi-finished products and products in process at the end of the period);

f. manufacturing costs for the period = (materials directly consumed in production for the period) + (direct labour costs) + (manufacturing expenses);

(b) Commerce:

a. taxable income = (profit on sales) + (profit from other operations) + (non-business income) - (non-business expenses);

b. profit on sales = (net sales) - (cost of goods sold) - (taxes on sales) - {[selling expenses] + [administrative expenses] + [financial expenses]};

c. net sales = (gross sales) - {[sales returns] + [sales discounts and allowances]};

d. cost of sales = (inventory of merchandise at the beginning of the period) + {(purchases of merchandise during the period) - (purchase returns) + (purchase discounts and allowances) - (purchasing expenses)} - (inventory of merchandise at the end of the period);

(c) Service industry:

a. taxable income = (net business income) + (non-operating income) - (non-operating expenses);

b. net business income = (gross business income) - {[taxes on business income] + [operating expenses] + [administrative expenses] + [financial expenses]};

(d) Other Types of Business; calculations shall be made by referring to the above formulae.

(GUO WU YUAN LING [85] 1991.6.30)

(14) In principle, the calculation of an enterprise's taxable income shall be on an accrual basis. The income from the following business operations of an enterprise may be determined by period, and used as the basis for calculation of taxable income:

(a) where products are sold by installment payments, income from the sales may be itemized according to the invoice date when the products are delivered; income from such sales may also be determined according to the date on which payment is made by the buyer, as agreed on in the contract;

(b) where construction, installation and assembly projects and provision of labour services extends beyond one year, the income may be determined according to the progress of the project or the amount of work completed;

(c) where processing or manufacturing of heavy machinery, equipment and ships for other enterprises extends beyond one year, the income may be determined according to the progress of the project or the amount of work completed.

(GUO WU YUAN LING [85] 1991.6.30)

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- (15) Where Chinese-foreign joint ventures operate on a product sharing basis, the partners shall be deemed to have received income at the time of the division of the products; the amount of income shall be calculated according to the price at which the products are sold to third parties or with reference to prevailing market prices.
Where foreign enterprises engage in cooperative oil exploration projects, the partners thereto shall be deemed to have received income at the time when the crude oil is divided; the amount of income shall be calculated using a price which is adjusted periodically with reference to the international market price of crude oil of a similar quality.(GUO WU YUAN LING [85] 1991.6.30)
- (16) With respect to an enterprise's income which is in the form of non-monetary assets or rights or interests, such income shall be calculated or appraised with reference to prevailing market prices.(GUO WU YUAN LING [85] 1991.6.30)
- (17) Where an enterprise cannot provide complete and accurate vouchers and documents for costs and expenses, and cannot correctly calculate taxable income, the local taxation authorities shall determine the profit rate and calculate taxable income by referring to the profit level of other enterprises in the same or a similar trade. Where an enterprise cannot provide complete and accurate certificates of revenues and cannot report income accurately, the local tax authorities shall calculate taxable income by the use of methods such as cost-plus-expenses plus a reasonable profit margin.
Where taxation authorities have to determine profit rates or revenues with reference to the provisions of the preceding paragraphs, but where other stipulations are provided by laws, regulations and rules, then these other stipulations will apply.(GUO WU YUAN LING [85] 1991.6.30)
- (18) Where foreign transportation and ocean shipping enterprises engage in international transportation business, they shall use 5% of their gross revenues from passenger and cargo transport and shipping service arising within the borders of China as their taxable income.(GUO WU YUAN LING [85] 1991.6.30)

2. Specific Regulations

- (1) On the matter of levying relevant tax on the business entertainment costs an enterprise with foreign investment incurs from direct supply of service in tourist hotels and restaurants it owns
- (a) If an enterprise with foreign investment invites guests to dinner at a restaurant belonging to the enterprise, the Industrial and Commercial Consolidated Tax shall be paid according to the taxable income from the dinner calculated at the sales price, and shall not be written off from the operating cost of the restaurant.
- (b) If goods such as cigarettes and alcoholic drinks sold by the enterprise with foreign investment are used to receive guests, they shall be listed in goods sold, the

Industrial and Commercial Consolidated Tax shall be paid according to the taxable income at their sales price, and shall not be written off from the stock of goods at cost price.

(GUO SHUI WAI ZI [081] 1989.3.25)

- (2) Actors or athletes shall pay tax, according to the following provisions, on the income earned by a performance organization, and by the actors or athletes as individuals, from theatrical performance and sports activities conducted in China (Mainland) by actors or athletes from abroad, Hong Kong, Macao or Taiwan in the name of the performance organization:

(a) The organization providing performances shall pay Business Tax of 3% on business income, i.e., the remainder obtained from the deduction of fees paid to the providers of performance sites, performance organizers or brokers from the total ticket income or from the income for theater bookings according to the relevant provisions in the "Provisional Regulations of the People's Republic of China on Business Tax" (hereinafter referred to as ; Regulations on Business Tax;).(GUO SHUI FA [106] 1994.4.21)

- (3) How to calculate the levy of Enterprise Income Tax on over-reimbursed tax

The enterprise with foreign investment shall calculate and pay enterprise Income Tax on the taxable income for the year including tax actually refunded, regardless of which tax year the overpaid tax belongs to, according to the relevant provisions in the "Income Tax Law on Enterprises with Foreign Investment and Foreign Enterprises".(GUO SHUI FA [145] 1994.6.27)

- (4) Taxation on the medical and educational business of enterprises with foreign investment

The enterprise with foreign investment engaged in education shall calculate and pay Business Tax on business income collected from students and from other sources except that stipulated to be tax free in Item 4, section 1, Article 6 of Business Tax Regulations regarding exemption from Business Tax. The enterprise shall calculate and pay Income Tax on the taxable income, i.e. the remainder obtained from deduction of costs, expenses and losses from total income (including income on which Business Tax has been reimbursed). A school established with investment from a foreign enterprise shall calculate and pay tax on business income from the interest received from pledge money which may not be dealt with as business income if, according to the school regulations or the entrance contracts, the school collects the pledge money first and returns it upon graduation and uses the interest from the pledge money as the tuition fee. If it is stipulated in the school regulations or entrance contracts that high tuition fees shall be collected first, and part of the fees shall be returned to students upon their graduation or to the students who leave school before graduation, while the other part is retained in the enterprise, then, the part of the fee to be returned to students shall be regarded as pledge money but not as business

income, and tax shall only be calculated and paid on the interest derived from the tuition fees and on the part of the fees to be returned to students.

The enterprise with foreign investment engaged in medical services shall calculate and pay Business Tax on all income except for that as mentioned in Item 3 of Section 1 in Article 6 of the Business Tax Regulations regarding Business Tax exemption. The enterprise shall calculate and pay Enterprise Income Tax on the remainder (as taxable income) obtained by deduction of relevant costs, expenses and losses from the total income.(GUO SHUI FA [152] 1994.7.4)

(5) Taxation on gifts of a public benefit or relief nature given by enterprises with foreign investment

Donations by an enterprise with foreign investment for welfare and relief within China may be categorized into and drawn from the enterprise's costs for the period. In the opinion of the State Administration of Taxation, the above donations refer to those offered by an enterprise with foreign investment for public welfare, such as education, civil administration and for relief in regions of natural disasters or poverty, via government bodies or non-profit social organizations in China (including China Development Foundation for Young Boys and Girls, Project Hope Foundation, Song Qingling Foundation, Disaster Reduction Committee, Red Cross Society of China, China Federation of the Handicapped, the National Foundation for Old Age, Promotion Society for Old Revolutionary Base Area and other welfare organizations established upon approval of the civil administration departments), but do not refer to those directly offered to beneficiaries.(GUO SHUI HAN [175] 1995.4.27)

If you wish to obtain more information or assistance, please visit the official website of Kaizen CPA Limited at www.kaizencpa.com or contact us through the following and talk to our professionals:

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