



JONES DAY COMMENTARY

CHINESE LOCAL GOVERNMENTS FIGHT FOR THEIR SHARE OF TAX REVENUE

In China, major taxes such as the corporate income tax ("CIT") are shared between the central government and the local governments. The current share ratio is 60 percent to the central government and 40 percent to local governments.

Prior to January 1, 2008, a foreign-invested enterprise (*i.e.*, an enterprise with foreign ownership of 25 percent or more) filed and paid CIT in the city where its head offices were "located." The combined CIT return included the income from all branches, regardless of branch location. Under that system, the tax bureau at the enterprise's headquarters collected 100 percent of the CIT from the enterprise. The local government retained 40 percent of the CIT collected and forwarded the remaining 60 percent to the central government. Cities with branch locations generally did not receive any tax revenues from those foreign-invested enterprises. For enterprises other than foreign-invested enterprises, branches were generally considered taxpayers and filed and paid CIT locally unless otherwise approved by the Ministry of Finance and/or

the State Administration of Taxation. The government at a branch location would retain 40 percent of the CIT collected and forward the remaining 60 percent to the central government.

Under the new unified Corporate Income Tax Law, which came into effect on January 1, 2008, all enterprises will file combined CIT returns, including the income or losses of headquarters and all branches, with the tax bureaus where the headquarters are located. If all CIT is paid to the tax bureaus at the headquarters locations, the tax revenues of many local governments, especially those in the inland provinces, will be reduced, as most corporate headquarters are located in the more developed cities in the coastal areas. In order to solve this revenue-shifting problem, the Ministry of Finance, the State Administration of Taxation, and the People's Bank of China issued Circular Cai Yu [2008] No. 10 ("Circular 10"), which provides the method for allocating CIT payments between the central and local governments from taxpayers with headquarters and branches across multiple provinces.

ALLOCATION OF PROVISIONAL TAX PAYMENT

An enterprise files quarterly or monthly CIT returns based on the income statement of the relevant period and pays provisional CIT on or before the 15th day following the end of the period. On or before the end of the fifth month after a tax year, the enterprise must file an annual CIT return and make a final CIT settlement (*i.e.*, pay additional tax or apply for an overpayment refund). According to Circular 10, the provisional tax payment should be allocated according to the following steps:

Step 1: Identify participating branches. Participating branches are the first-tier branches with principal operational functions. The second- or lower-tier branches should be consolidated into the first-tier branches for calculation of tax payment allocation. The first-tier branches that undertake no principal operational functions and do not pay business tax or VAT at their locations do not participate in the allocation. Excludable branches include those providing

after-sales services, internal R&D, warehousing, and other internal ancillary functions. A new branch does not participate in the allocation for the year in which it is set up. A dissolving branch stops participating the year after it is dissolved.

Step 2: Allocation between headquarters and participating branches. During each provisional CIT filing, the CIT payable by an enterprise will initially be allocated 50 percent to the headquarters and 50 percent to the participating branches. Accordingly, the enterprise should pay 50 percent of its CIT for the period (quarter or month) to the tax bureau at the headquarters location.

Step 3: Allocation among the participating branches. The 50 percent of provisional CIT allocated to the participating branches in Step 1 will be further allocated among those branches based on three factors: gross revenue, payroll, and total assets. CIT paid to the tax bureau at one participating branch location should be equal to the following:

$$\begin{array}{ccccccc} & & \text{Revenue} & & \text{Payroll} & & \text{Assets} \\ & & \text{of the branch} & & \text{of the branch} & & \text{of the branch} \\ 50\% \text{ of total CIT} & \times & \text{-----} & \times 0.35 & + & \text{-----} & \times 0.35 & + & \text{-----} & \times 0.30 \\ \text{for the period} & & \text{Revenue} & & \text{Payroll} & & \text{Assets} \\ & & \text{of all} & & \text{of all} & & \text{of all} \\ & & \text{participating} & & \text{participating} & & \text{participating} \\ & & \text{branches} & & \text{branches} & & \text{branches} \end{array}$$

The amounts of revenue, payroll, and assets used in the formula for periods from January to June should be the numbers for the year before last year; for periods from July to December, the numbers from the previous year should be used.

DISTRIBUTION OF PROVISIONAL TAX PAYMENT

The provisional tax paid to the tax bureaus at headquarters and participating branches will be distributed within the government. Sixty percent of the CIT collected by the tax bureau at a participating branch location will be forwarded to the central government, and the remaining 40 percent will stay with the local government. Sixty percent of the CIT collected

by the tax bureau at the location of the headquarters will be forwarded to the central government; of the remaining 40 percent, 50 percent will stay with the local government and 50 percent will be allocated to a temporary account at the central government for distribution to local governments. This temporary account will be regularly distributed to local governments by the Ministry of Finance according to a predetermined sharing ratio.

ANNUAL TAX FILING

Only the headquarters of the enterprise is required to perform an annual CIT filing. Provisional CIT paid at headquarters

and participating branch locations will be credited against the total CIT liability of the enterprise shown on its annual CIT return. The enterprise will pay additional CIT to, or obtain an overpayment tax refund from, the tax bureau at the location of the headquarters. Sixty percent of the CIT collected for annual filings will go to the central government. The remaining 40 percent will go into a temporary account and will be earmarked for distribution to local governments.

POTENTIAL IMPACTS AND UNCERTAINTY

The new CIT filing system under Circular 10 appears to be the result of the ongoing revenue-sharing battle between local governments. This allocation method may not necessarily end the battle. The arbitrary 50/50 allocation of total provisional tax between headquarters and branches may have an inequitable result in many situations. For example, even if almost all of a taxpayer's operations are at the headquarters location, 50 percent of its provisional CIT would be allocated to its small operating branch in another province. As another example, if a branch was established in 2007, the branch may participate in the allocation for 2008. For calculating provisional tax payments for January through June 2008, the enterprise should use annual revenue, payroll, and asset numbers for 2006 (*i.e.*, before the branch existed). These and other issues will need further clarification.

Under the old tax regime, some foreign-invested enterprises classified many of their branches as cost centers and did not allocate revenue to such branches. The new filing system has provided incentives for the tax bureau at branch locations to challenge this practice. If the tax bureau at a branch location successfully reclassifies the branch as a participating branch and assesses underpayment of tax, the enterprise may not be able to obtain a refund from the tax bureaus at the headquarters or other participating branch locations. Taxpayers should carefully consider all the facts and make a proper determination regarding participating branches. Classifying more branches as participating branches generally should not affect the taxpayer's CIT liability. However, it may increase the administrative burden for tax filings.

LAWYER CONTACT

For further information, please contact your principal Firm representative or the lawyer listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Fuli Cao

86.10.5866.1223

fcao@jonesday.com

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