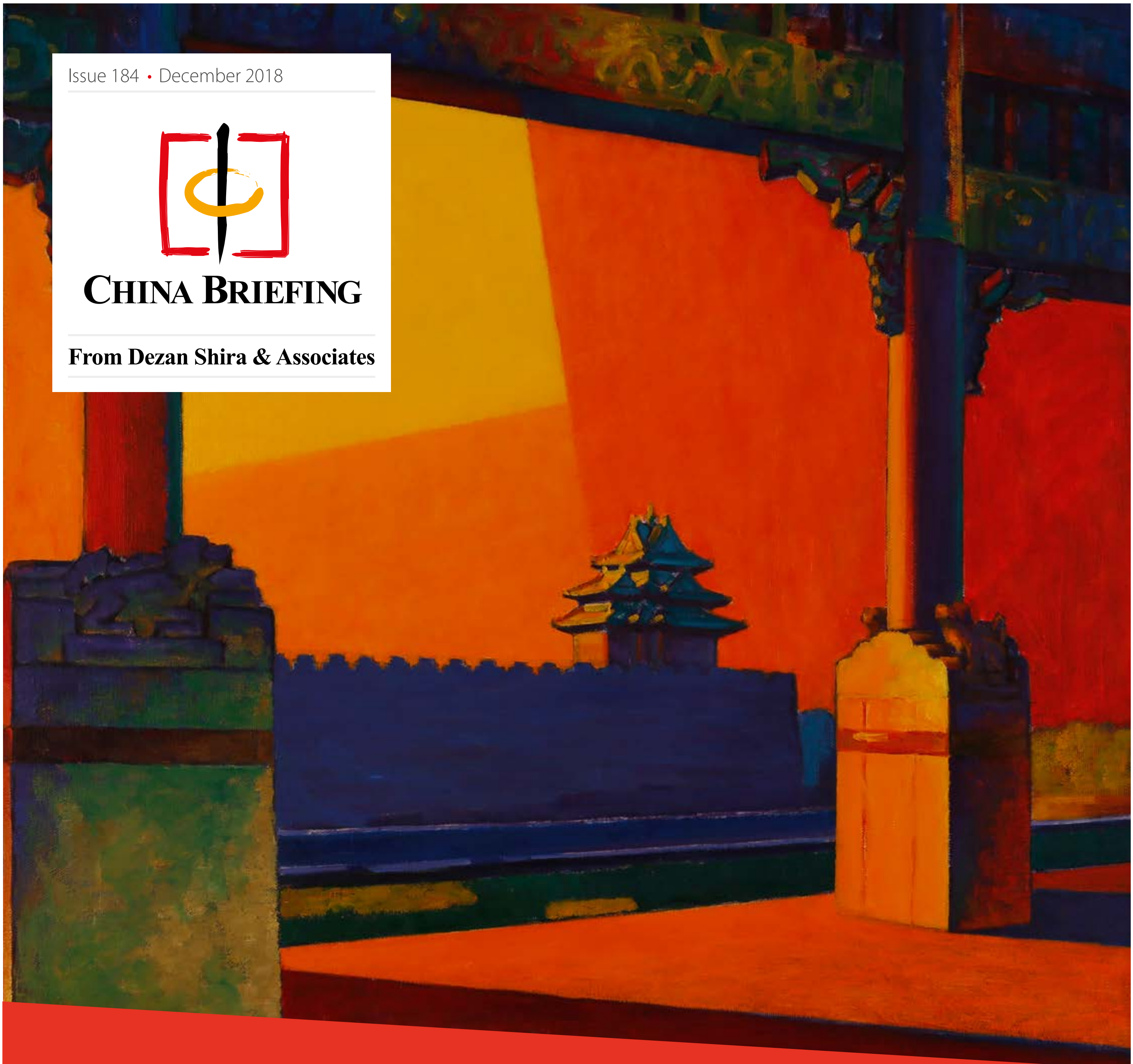
Issue 184 • December 2018

CHINA BRIEFING

From Dezan Shira & Associates



Annual Audit and Compliance in China

www.china-briefing.com

Introduction

SABRINA ZHANG
Partner
Dezan Shira & Associates
Beijing Office

The start of a new year tends to be a hectic time for foreign companies in China. Businesses must renew their annual licenses and adapt to new laws and regulations that are coming into effect, all while managing the workflow interruptions of the holiday season and upcoming Chinese New Year celebrations.

During this period, businesses must also begin to prepare their annual statutory audit – if they have not started to do so already. To meet the various deadlines scattered throughout the year, businesses need to begin the long and complicated process of financial reporting months in advance. If businesses fail to comply, they risk being hit with additional fines and penalties, and might not be able to remit their profits overseas.

Beyond meeting statutory requirements, however, the annual audit represents an opportunity for businesses to conduct a deep dive into their finances and internal operations. A comprehensive audit might reveal unexpected irregularities or suboptimal business practices, or discover eligibility for tax incentives that had not previously been captured.

In this issue of China Briefing magazine, we walk foreign businesses through the annual audit and compliance process from start to finish. We begin by answering the common questions that foreign investors ask about annual audit in China, before offering a comprehensive step-by-step guide to completing the process. Finally, we offer six recommendations for businesses to better conduct annual audit and make the most out of the opportunity.

We hope this magazine helps your business add value to its annual statutory audit and compliance reporting in China.

With kind regards,

Sabrina Zhang

ASIA BRIEFING
www.asiabriefing.com

Asia Briefing Ltd. Unit 507, 5/F, Chinachem Golden Plaza, 77 Mody Road, Tsim Sha Tsui East Kowloon, Hong Kong.

DEZAN SHIRA & ASSOCIATES
www.dezshira.com

ASEAN BRIEFING
www.aseanbriefing.com

CHINA BRIEFING
www.china-briefing.com

INDIA BRIEFING
www.india-briefing.com

INDONESIA BRIEFING
www.indonesiabriefing.com

VIETNAM BRIEFING
www.vietnam-briefing.com

Reference
China Briefing and related titles are produced by Asia Briefing Ltd., a wholly owned subsidiary of Dezan Shira Group.

For queries regarding the content of this magazine, please contact:
editor@asiabriefing.com

Credits
Publisher / Sabrina Zhang
Managing Editor / Adam Pitman
Contributor / Hannah Feng, Susan Ma, Ivy Gu, Daisy Huang
Editor / Qian Zhou
Design / Belén Rodríguez

This Issue's Topic

Annual Audit and Compliance in China

Table of Contents

This Month's Cover Art
Tian Li 田力
皇城系列
80x80 cm
Wan Fung Art Gallery
wanfung@126.com.cn
+86 0760 8333 861
www.wanfung.com.cn

Annual Audit FAQs

By Dezan Shira & Associates
Editor: Qian Zhou

According to China's Company Law and other relevant regulations, all foreign invested enterprises (FIEs) in China, including wholly foreign owned enterprises (WFOEs), joint ventures (JVs), foreign invested commercial companies (FICEs), and representative offices (ROs), are required to comply with the annual audit and other compliance processes.

While the way in which China's audit process functions in now more closely aligned with Western practices than in the past, there are still a number of differences and idiosyncrasies that can quite easily trip up a foreign firm. Below, we list out some essential aspects of the annual audit in China that businesses need to know.

Why is the annual audit important to FIEs in China?

FIEs can only distribute and repatriate their profits or dividends back to their home country after completing their annual audits and settling all relevant tax liabilities. Failure to comply with the annual audit and related measures may result in extra expenses, penalties, or even revocation of business licenses.

When FIEs initially began setting up in China, many were not familiar with Chinese accounting standards and tax rules. This resulted in incorrect accounting treatments or tax filings, especially amongst small- and medium-sized FIEs. Through the annual audit process, auditors can help businesses find mistakes in day-to-day operations. In this way, FIEs could improve their financial reports in accordance with Chinese accounting standards, and ensure that accounting data is presented appropriately.

The annual audit is also an appropriate time to double-check an FIE's tax obligations and identify unnecessary tax payments that can be refunded, which will additionally improve a company's accounting system.

What's the right time to initiate the annual audit process?

FIEs typically start preparing for China's annual audit in January. However, tax advisors usually suggest enterprises to start the process earlier in November or December, based on the below considerations:

Firstly, it saves time. During the rush period in late January and February when everyone is scrambling to get their audit reports finished, a company who has done a preliminary audit can finish their final audit by analyzing the data of the last 1-2 months.

More importantly, it allows for a more comprehensive audit, and can therefore help senior management gauge the efficiency of the financial workings of their company. Potential problems are easier to spot and can be resolved earlier.

Additionally, an early audit means that, if any changes need to be made in terms of how the company and its finances are run, or in internal control management, they can be implemented before or at the start of the New Year.

What are the key areas in an annual audit?

For JVs, WFOEs and FICEs, accounts related to purchases and sales are usually the most vulnerable areas in an annual audit, and so more time would typically be spent reviewing these accounts and ensuring that the accounting data is genuine and accurate. This is done by comparing the transactions with the corresponding contracts, invoices, orders, and inventory changes.

In addition, it is quite common for FIEs new to China to conduct most of their transactions with affiliated companies overseas. For example, they would import from their foreign parent company and either sell the products domestically, or export products purchased from China to their overseas affiliates. These transactions can raise issues in transfer pricing and bring the foreign company into non-compliance with the Chinese tax bureau.

For ROs, because daily business operations are relatively simple compared to other types of FIEs, more attention will be paid on expense accounts and financial statements.

How does the annual audit relate to taxation?

The annual audit relates to taxation because it can detect the potential bookkeeping mistakes and other related problems before the tax reconciliation deadline. This removes problems relating to tax risk and compliance with China's taxation laws.

The tax bureau may also compare the information in the corporate income tax reconciliation report with that in the annual audit report.

How does annual audit relate to internal control systems?

The annual audit is a good opportunity to enhance a company's internal control systems. Again, an early audit will allow enough time for auditors to conduct a comprehensive review of the internal control systems of a company. The results of this review will allow management to evaluate internal control systems and make corresponding changes in the new year.

The same audit process is very important for small- and medium-sized foreign companies to assess the financial performance of the China arm of their business, and is worthwhile even aside from meeting China's auditing and taxation obligations. Dezan Shira & Associates advises companies to also start the audit process as soon as possible.

Internal Control Review Integrated in the Annual Audit Process

Unlike listed companies, which are required by law to conduct separate internal control audit and evaluation regularly, internal control review is generally not mandatory for smaller companies. In these cases, it is usually combined into the annual audit process. Generally, the internal control review process is as fallows:

Internal Control Review Process-Full Set

01 Identify the company's business objectives

02 Walk-through test to learn the key business process and controls

03 Document key processes and controls

04 Identify key control points for further review

05 Test the effectiveness of key control points

06 Analyze control deficiencies and assess corresponding risks

07 Generate ICR report

08 Follow-up monitor and review

Step-by-Step Annual Audit Guide for JVs, WFOEs, FICEs, and ROs

By Dezan Shira & Associates

Editor: Qian Zhou

China has various nuanced annual audit procedures that foreign invested enterprises (FIEs) will have to follow in order to achieve full compliance. Here, we provide a step-by-step guide to these procedures, including general requirements, key considerations, and materials to be prepared, with notes on regional differences and tips from experienced accountants and auditors.

Annual audit and tax compliance for JVs, WFOEs, and FICEs

For wholly foreign owned enterprises (WFOEs), joint ventures (JVs), and foreign invested commercial enterprises (FICEs), achieving annual compliance can be a long and complicated process. The work primarily involves producing an annual audit report, a corporate income tax (CIT) reconciliation report, and reporting to relevant government bureaus.

These procedures are not only required by law, but are also a good opportunity to conduct an internal financial health check. The relevant procedures and key considerations vary slightly by region and entity type. Companies should either contact a service provider or the local government to achieve full compliance.

Step 1 - Prepare an annual audit report

The annual audit report consists of a balance sheet, an income statement, and a cash flow statement. To ensure that foreign-invested companies meet Chinese financial and accounting standards, the annual audit report must be conducted by external licensed accounting firms and signed by a Certified Public Accountant (CPA) registered in China for compliance purposes.

The requirements for the audit report vary by region. For instance, in Shanghai, companies must include a taxable income adjustment sheet in the audit report, which is not a necessary supplement in Hangzhou, Beijing, or Shenzhen. The audit procedure takes about two months, and the audit report should be completed before the end of April in order to meet the May 31 tax reconciliation deadline.

Step 2 - Prepare CIT reconciliation report (annual tax returns)

In China, CIT is paid on a monthly or quarterly basis in accordance with the figures shown in the accounting books of the company – companies are required to file CIT returns within 15 days from the end of the month or quarter. However, due to discrepancies between China's accounting standards and tax laws, the actual CIT taxable income is usually different from the total profits shown in the accounting books.

Annual Compliance Timeline*

*Subject to regional variation
**Subject to yearly variance

As such, the State Administration of Taxation (SAT) requires companies to submit an Annual CIT Reconciliation Report within five months from the previous year's year-end to determine if all tax liabilities have been met, and whether the company needs to pay supplementary tax or apply for a tax reimbursement.

Every year around March, depending on the location, the local tax bureau will issue annual guidance on CIT reconciliation. Generally, the Annual CIT Reconciliation Report must include adjustment sheets to bridge the discrepancies between tax laws and accounting standards. FIEs that conduct frequent transactions with related parties should prepare an Annual Affiliated Transaction Report on transfer pricing issues as a supplementary document to the Annual CIT Reconciliation Report.

Moreover, FIEs in certain regions need to engage a Certified Tax Agent firm in China to prepare another separate CIT audit report. In Beijing, this requirement applies to firms that meet the following conditions:

- Yearly sales revenues exceed RMB 30 million (approx. US$4.35 million);
- Carrying over last year's losses to deduct this year's income; or,
- Yearly losses exceed RMB 100,000 (approx. US$14,500).

In Shanghai, the CIT audit report is needed when:

- Taxpayers who have made a loss (current year loss) of more than RMB 5 million (approx. US$0.73 million); or,
- Taxpayers who have offset losses carried forward from previous years.

The deadline for submitting the CIT Reconciliation Report to the tax bureau is May 31 every year, but the investigation of the tax compliance could last to the end of the year, and companies should be prepared to provide supporting documents upon demand from the tax bureau.

Step 3 - Annual reporting to AIC

According to the "Interim Regulations for the Publicity of Corporate Information", each year from January 1 to June 30, all FIEs should submit an annual report for the previous fiscal year to the relevant Administration of Industry and Commerce (AIC). This should be done through the corporate credit and information publicity system.

The annual report submitted should cover the following information:

- The mailing address, post code, telephone number, and email address of the enterprise;
- Information regarding the existence status of the enterprise;

- Information relating to any investment by the enterprise to establish companies or purchase equity rights;
- Information regarding the subscribed and paid in amount, time, and ways of contribution of the shareholders or promoters thereof, in the case that the enterprise is a limited liability company or a company limited by shares;
- Equity change information of the equity transfer by the shareholders of a limited liability company;
- The name and URL of the website of the enterprise and of its online shops;
- Information of the number of business practitioners, total assets, total liabilities, warranties and guarantees provided for other entities, total owner's equity, total revenue, income from the main business, gross profit, net profit, and total tax; and,
- Information regarding customs annual reporting of enterprises subject to the administration of the customs.

Annual Custom Reporting Combined with Annual Reporting to AIC

From 2018, enterprises subject to customs administration are no longer required to submit the annual customs report through separate customs platforms. Rather, they can submit the relevant customs information through the corporate credit and information publicity system during annual reporting to the AIC. Enterprises subject to customs administration refer to enterprises that are registered with the customs, which include declaration enterprises, processing enterprises, and enterprises enjoying tax reduction for importing machines.

As the first year of reform, in 2018 enterprises subject to customs administration can fill in the relevant customs information from May 31 to August 31. Going forward, the reporting time period will be the same as that for other enterprises, or January 1 to June 30.

Step 4 - Annual combinative reporting to MOFCOM, MOF, SAT, AQSIQ, NBS and SAFE

Besides the annual reporting to AIC, FIEs in China are required to conduct an annual combinative reporting to Ministry of Commerce (MOFCOM), Ministry of Finance (MOF), SAT, State Administration of Foreign Exchange (SAFE), and National Bureau of Statistics (NBS).

Unlike the previously implemented annual inspection system, annual reporting compels relevant government bureaus to take on the role of supervisors, rather than judges. They no longer have the right to disapprove reports that are submitted, even if they think the reports are unqualified – they can only suggest that the FIEs make modifications. Accordingly, relevant government bureaus no longer affix any seals on a report. Under this system, all information can be submitted online through the annual combinative reporting system.

In 2018, the previous foreign exchange reconciliation was further combined into the annual combinative reporting system. FIEs are no longer required to conduct a separate foreign exchange reconciliation registration. As an alternative, enterprises can submit foreign exchange relevant information together with other information through the annual combinative reporting system.

With this new rule implemented, the annual compliance requirements for FIEs have become much more manageable.

The deadline for this combinative report is subject to yearly variance. In 2017, the deadline was delayed to July 15. And in 2018, the reporting period is from April 1 to June 30.

Annual Foreign Exchange Reconciliation Combined into Annual Combinative Reporting

All foreign exchange transactions in and out of China are strictly controlled by SAFE, the bureau under the central bank of China (the People's Bank of China).

Previously, according to the "Notice on Further Simplifying and Improving the Foreign Exchange Management Policies for Direct Investment" (Hui Fa [2015] No.13), effective since June 1, 2015, relevant market players were required to make an "Existing Right Registration" before September 30 each year.

To cut red tape, starting from the year 2018, FIEs are no longer required to conduct separate annual foreign exchange reconciliation. As an alternative, they can submit foreign exchange relevant information through the annual combinative reporting system (*http://www.lhnj. gov.cn/*). In 2018, the deadline is June 30.

Failure to comply with registration requirements results in the foreign exchange bureaus taking control over the parties in the capital account information system. Further, banks will not carry out foreign exchange business under the capital account for offending companies.

Annual Compliance Timeline for ROs

Step 1
Prepare Audit Report

Step 2
Tax Filing
Deadline May 31*

Step 3
Annual Reporting to AIC
Deadline June 30*

** Deadlines can vary depending on the locality of the enterprise. FIEs should consult their local tax authorities in charge.*

Annual audit and tax compliance for ROs

For ROs, annual compliance procedures are simpler. While ROs are exempt from annual combinative reporting, they still need to prepare annual audit report, a tax reconciliation report, and then report to AIC.

Step 1- Prepare annual audit report

Similar to the annual audit for JVs, WFOEs, and FICEs, the annual audit report for ROs should also be prepared by external licensed accounting firms and signed by a CPA registered in China. When doing the annual audit works, auditors should pay special attention to the following factors.

- **Bank statements, cash, staff, and IIT**— The balance on the bank book should be the same as that stated in the bank statement. If not, a bank reconciliation should be prepared to verify the differences. The balance on the account should be the same as the cash contained in the cash box. The auditors will perform a cash count during their field work. Employment of staff has to be registered in accordance with the relevant regulations (local employees registered with FESCO and valid work permits for expatriate staff), and IIT correctly assessed and filed.

- **Expenses report** — Expenses include rent, transportation, telephone, salary, office purchases, entertainment, audit fees, utilities, and FESCO fees, regardless of whether these are paid from the RO or directly from its head office. Any expenses belonging to the fiscal year should be properly accrued with contracts or agreements as support. The total salary of the chief representative, whether paid offshore or locally, has to be included in the expenses. If employees are involved in overseas social security plans, these payments have to be included in the expenses report.

- **Taxable income** — According to relevant laws and regulations, ROs of foreign enterprises in mainland China must pay CIT on their deemed taxable income, as well as value-added tax (VAT) and consumption tax (CT) when it is applicable. The CIT liability will be assessed by the deemed profit method, cost-plus method, or actual revenue method. Among these three methods, the cost-plus method is the most commonly used, since the other two methods require ROs to submit numerous supporting documents. Under the cost-plus method, the taxable income, i.e. the deemed revenue, is calculated on the basis of the expenses:

DEEMED REVENUE = RO´S EXPENSES / (1 - DEEMED PROFIT RATE*)

**The deemed profit rate is decided by the tax bureau, and shall be no less than 15%.*

Step 2 - Annual tax filing

The responsibility for tax filing in China is with the taxpayer. The tax bureau does not send out tax returns; the taxpayer has to collect and file tax forms according to relevant regulations. The tax authority additionally requires that accounting records and ledgers be set up and kept properly and that details of the accounting system be filed.

The annual tax reconciliation is finished through the online filing wholly. ROs usually will need to submit the Annual Taxation Consolidation Report to the tax bureau by the end of May each year, but regional variations may exist. If the audited taxes due are found to be different from the taxes paid by the RO, the RO shall discuss the variation with the tax bureau. For foreign companies that suspect this might occur, it is wise to hold preemptive discussions with tax advisors prior to audit submission.

Step 3 - Annual reporting to AIC

ROs are required to submit an annual report between March 1 and June 30 every year providing information on the legal status and standing information of the foreign enterprise, ongoing business activities of the RO, and an audit report. The registration authorities will issue an RMB 10,000 to RMB 30,000 penalty if the RO fails to provide these reports on time, and an RMB 20,000 to RMB 200,000 penalty if the report includes false information. Fraud may also lead to license revocation.

During the annual reporting process, the following documents should be provided in paper or online:

- Annual report (the template will be distributed by AIC around March);
- Business registration certificate;
- Audit report; and,
- Proof of information on the legal status and standing of the headquarters overseas.

Annual Audit Checklist: Six Ways You Can Prepare

By Dezan Shira & Associates
Editor: Qian Zhou

According to the Corporate Income Tax (CIT) Law, whenever there are discrepancies between China's accounting standards and tax laws, the tax laws shall prevail in annual CIT reconciliation. Enterprises should therefore conduct a comprehensive examination of all tax-related matters for the year during the annual tax settlement.

By focusing on certain areas during the audit, an enterprise can not only get the most from the annual audit, but also avoid potential risks in any tax investigations. Below, we list out some typical areas that enterprises should pay attention to.

1. Check if your company utilized all tax and fee reductions

During the year-end check, enterprises should check if they have used up all preferential tax policies provided in the country. This is especially important in 2018: the state government implemented a number of tax and fee reduction policies to support businesses.

For example, according to the "Notice on Further Expanding the Scope of Income Tax Preferential Policies for Small and Low Profit Enterprises" (Cai Shui [2018] No. 77), enterprises with a taxable income not exceeding RMB 1 million will be allowed to pay CIT at the rate of 20 percent on only 50 percent of their taxable income for the period of January 1, 2018 to December 31, 2020. Specifically, if the enterprise prepays CIT based on its actual profit for the current year, and the accumulative actual profit at the time of making the prepayment is less than RMB 1 million, it is entitled to the reduced tax.

This policy came into effect on January 1, 2018, and will be valid until December 31, 2020. In the past two years, the upper limit to enjoy this incentive has been raised twice: from RMB 300,000 to RMB 500,000 in 2017, and from RMB 500,000 to RMB 1 million most recently.

2. Check if the expense deduction caps were reached

According to CIT Law, reasonable expenditure incurred in relation to income received by an enterprise can be deducted from gross income. This usually include costs, expenses, taxes (except CIT and VAT) and losses; reasonable depreciation of fixed assets; amortization of intangible assets; amortization of long-term prepaid expenses; inventory cost; net value of an asset transferred; other deductions stipulated by laws and regulations.

However, China also imposed caps on the amount of certain expenditures that can be deducted. For example, according to the "Notice on Policies Concerning the Pre-CIT Carry-forward and Deduction of Expenditures for Public Welfare Donation" (Cai Shui [2018] No. 15), qualified

Deduction Caps for Certain Expenses

Expenses	Deduction cap
Employee welfare	≤14% of the total amount of employee salaries and wages
Labor union funds	≤2% of the total amount of employee salaries and wages
Employee education	≤8% of the total amount of employee salaries and wages (the excess can be carried forward to future years for deduction)* 100% deduction for enterprises in software and integrated circuit industries
Business entertainment relating to production and business operations	≤ 60% of the actual incurred amount but not more than 0.5% of the sales revenue of the current year
Advertising and publicity**	≤15% of the sales revenue of the current year (the excess can be carried forward to future years for deduction)

**Originally, the 8% deduction cap was only available for advanced technology service enterprises. But starting from January 1 2018, it was extended to cover all enterprises unless it is stipulated otherwise.*

*** From January 1, 2016 to December 31, 2020, for enterprises manufacturing or selling cosmetics, enterprises manufacturing pharmaceuticals, and enterprises manufacturing beverages (excluding alcohol), the deduction cap of advertising fee is 30% of the sales revenue of the current year (the excess can be carried forward to future years for deduction). Advertising fees paid by the tobacco enterprises are not deductible.*

donations made by an enterprise for the purpose of charitable activities or public welfare undertakings are allowed to be deducted from the enterprise's taxable income, provided that such donations are not higher than 12 percent of the enterprise's annual total profit. If such donations exceed 12 percent of the enterprise's annual total profit, the part in excess may be carried forward to the next three years for deduction when the taxable income is calculated.

The enterprise public welfare donation expenditure is calculated based on the profit before the enterprise income tax deduction. In addition to checking whether the unit donation is in line with the public welfare donation, the annual total profit must be accurately calculated. If the tax adjustment is needed, it should be handled correctly.

Besides the donation expenditure, deduction caps apply to certain other expenses, as shown in the above table.

3. Check if asset confirmation was timely and accurate

The enterprise should also examine large expenses and capital expenditures, and avoid expensing capital expenditures. It is necessary to conduct a comprehensive review of the depreciation of fixed assets and amortization of intangible assets.

Generally, when calculating CIT taxable income, the reasonable depreciation of fixed assets is deductible. Fixed assets refer to the non-currency assets held and used by the enterprises for over 12 months. To determine the depreciation of fixed assets each year, the straight-line method is applied.

The straight-line method takes the purchase or acquisition price of an asset, subtract from it the salvage value, and divide this by the total productive years the asset can be reasonably expected to benefit the company (i.e. useful life):

ANNUAL DEPRECIATION = (COST - SALVAGEVALUE) /MINIMUM USEFUL YEARS

Minimum Useful Years for Fixed Asset Depreciation

Fixed assets	Useful years
Premises and buildings	20
Planes, trains, ships, machinery, and other manufacturing equipment	10
Instruments, tools, and furniture related to production and business operations	5
Means of transport other than planes, trains, and ships	4
Electronic equipment	3

However, according to "Notice on CIT Deduction Policies Relating to Equipment and Instruments" (Cai Shui [2018] No. 54), during the period from January 1, 2018 to December 31, 2020, enterprises' expenses on newly purchased equipment and instruments are eligible for a one-time deduction from CIT taxable income if the unit price is no more than RMB 5 million. That is to say, the expenses on purchasing eligible equipment and instruments are no longer required to be deducted year-by-year based on the annual depreciation during the given period.

Under this circumstance, there might be difference of tax payment between the accounting standards and the new depreciation rules. To clarify, if the current capitalization threshold under the accounting standards is RMB 5,000, the new threshold for capitalization under the tax law is RMB 5,000,000. Therefore, all fixed assets with a unit price between RMB 5,000 and RMB 5,000,000 would still have to be depreciated over its useful life under the accounting standards, whereas the amount of purchase between RMB 5,000 and RMB 5,000,000 would have to be subtracted as a lump sum in the year it was purchased for CIT deduction purpose under the tax law, and the depreciation shall be adjusted back year-by-year over the asset's residual life. This creates the need for tax adjustment in the following years.

According to the "Announcement on Issues Concerning the Implementation of Corporate Income Tax Policies Concerning Deductions for Equipment and Appliances" (State Administration of Taxation (SAT) Announcement No. 46 of 2018), where an enterprise opts to enjoy the lump-sum pre-tax deduction policy, its assets could be treated differently for tax and accounting purposes. In this case, it is necessary to check whether the tax difference is handled correctly.

4. Check whether pre-tax deduction vouchers are in compliance

Pre-tax deduction vouchers refer to various proofs used by an enterprise when computing taxable income for CIT purposes. This pre-tax exercise helps prove that the reasonable expenditure related to income was actually incurred.

According to the "Administrative Measures on Pre-tax Deduction Voucher for Corporate Income Tax" (SAT Announcement [2018] No. 28), the pre-tax deduction voucher is classified as an internal or external voucher, based on the source.

Internal voucher refers to the original accounting vouchers prepared by an enterprise for accounting of costs, expenses, losses and other expenditure. External voucher refers to proof documents for expenditure obtained by an enterprise from other organizations, including, but not limited to, invoices (such as hard copy invoices and electronic invoices), government revenue receipts, tax payment proof, collection proof, split receipts and others.

Enterprises should obtain pre-tax deduction voucher prior to expiry of the computation and settlement period for the current year, and properly maintain materials such as contract, agreement, basis for expenditure, payment proof and other materials for future inspection, to confirm the veracity of the pre-tax deduction voucher. If the enterprise is unable to provide the relevant materials that can prove the veracity of the said expenditure, the expenditure shall not be allowed for pre-tax deduction in the year in which it is incurred.

As such, enterprises should conduct a special check on all the pre-tax deduction vouchers received, and adopt corresponding management methods based on the results. For internal vouchers, the focus should be put on the inspection and improvement of fixed asset delivery orders, payrolls, and cost calculations. For external vouchers, the enterprise should take precautionary measures to avoid failure of obtaining an invoice or other external proof, or avoid obtaining a non-compliant invoice or external voucher.

5. Check accuracy of additional R&D expense deductions

In an effort to encourage innovation, the CIT Law stipulates that qualified resident companies in China can enjoy pre-tax additional deductions based on their research and development (R&D) expenditures.

According to "Notice on the Increase in the Proportion of Additional Pre-tax Deduction of Research and Development Expenses" (Cai Shui [2018] No. 99), during the period from January 1, 2018 to December 31, 2020, where the R&D expenses incurred by an enterprise in its R&D activities do not form intangible assets and are included in the current period's profit or loss, on the basis of actual deduction, an additional 75 percent of such R&D expenses could be deducted from the taxable income amount of the year. Where intangible assets are formed, pre-tax amortization shall be made based on 175 percent of the costs of the intangible assets during the aforesaid period.

To enjoy the pre-tax additional deduction of R&D expenses, enterprises should also comply with other laws and regulations, such as "Notice on Relevant Policies for the Pre-tax Weighted Deduction of Expenses for Overseas Research and Development Commissioned by Enterprises" (Cai Shui [2018] No. 64), on the scope of the R&D activities and expenses, accounting of R&D expenses, and management of R&D expenses.

6. Check whether documents for CIT incentives are prepared

According to "Measures on Handling of Corporate Income Tax Incentives" (Revision 2018) (SAT Announcement [2018] No.23), enterprises can judge if they are qualified to enjoy the CIT incentives by themselves, enjoy the incentives when they make CIT returns (at the time of pre-payment or final settlement, depending on the specific incentive), and retain relevant documents for potential inspection from the tax bureaus. This significantly simplifies the previous record-filing procedures for enjoying CIT incentives.

Along with the streamlined system, the SAT issued the "Catalogue for Administration of Preferential CIT Policies (2017 version)", which provides a list of 69 tax items that are covered by the simplified procedures. The Catalogue also clarified what documents should be retained and the administrative procedures for different types of CIT incentives.

For example, qualified advanced technology service enterprises (ATSE) that enjoyed the preferential CIT rate of 15 percent should prepare and retain the following materials for future reference:

- Official document on recognition of the ATSE;
- Other information and materials related to recognition of the ATSE;
- A fact sheet on the percentage of the revenue generated from advanced technology services listed in the "Scopes of Recognized Advanced Technology Service Business [For Trial Implementation]" in the total revenue, and the percent of revenue generated from offshore service outsourcing business (the information technology outsourcing (ITO) services, technical business process outsourcing (BPO) services and technical knowledge process outsourcing (KPO) services specified in the Scopes of Recognized Advanced Technology Service Business [For Trial Implementation]) in the total revenue of the current year; and,
- A fact sheet on the percentage of its staff holding college degree or above among its total employees.

Enterprises should pay special attention to the materials required to retain for the incentives they enjoyed upon self-judgement.

DEZAN SHIRA & ASSOCIATES
Your Partner for Growth in Asia

www.dezshira.com

*Is your company managing **taxes** effectively and efficiently?*

Consult our tax experts about maximizing revenue and minimizing unnecessary costs and risks for your business.

Paul Dwyer
Director
Head of International Tax and Transfer Pricing
Mob: +86 132 6260 0635
Email: paul.dwyer@dezshira.com

Introduction

Dezan Shira & Associates is a multi-disciplinary professional services firm operating throughout the Asia-pacific (APAC) region providing tax, legal, audit, accounting and advisory services. Beginning life in Hong Kong and Shenzhen in 1992, we have grown over the past quarter century to have over 20 offices and several hundred staff across the region and work closely with our alliance partners in Australia, EU and USA.

Our tax practice

Dezan Shira's tax practice specifically focuses on providing advice to foreign companies in relation to their investments and business activities in Asia. Dezan Shira has dedicated corporate tax, international tax, transfer pricing, indirect tax, individual income tax as well as customs and trade tax teams which are highly experienced and specialised. These departments are experts in their respective fields and have a strong working relationship with the tax authorities on all levels.

- Corporate tax
- International tax and cross border transactions
- Transfer pricing
- Indirect tax
- Individual income tax
- Customs and trade

Our Services

- Business Intelligence
- Corporate Establishment and Structuring
- Due Diligence
- Accounting
- HR and Payroll
- **Tax**
- Audit and Risk Advisory
- Technology
- Outbound Direct Investment

CONTACT US