



China's 12th Five-Year Plan has set an ambitious economic agenda; tax policy plays a pivotal role in achieving many of the nation's goals. Upcoming changes to the tax code will have far-reaching consequences for individuals and businesses.

"We will make better use of taxes in adjusting the economy and distributing income, to stimulate enterprises' development, guide consumer spending and accelerate the transition of the development pattern."

- Minister of Finance Xie Xuren, 7 March 2011

Tax policy as a driver of change

The National People's Congress approved the 12th Five-Year Plan (5YP) in March 2011, laying out the blueprint for the nation's development from 2011 to 2015. As a major source of the nation's fiscal revenue and a powerful tool for macro economic transformation, taxation is critical to the 5YP.

- Based on the broad themes outlined in the 12th 5YP, China's government is now drafting detailed tax law changes. These new tax measures will help China reach its goals in terms of:
 - distributing wealth more evenly
 - encouraging consumption
 - discouraging negative behaviours (for example excessive energy use and pollution)
 - developing key regions, such as Western and Central China
 - restructuring the economy (for example with support for the services sector).

Summary of anticipated tax measures during the 5YP

5YP theme

- Domestic consumption
- Reducing disparities

- Environmental protection
- Energy efficiency

- Development of Western and interior regions
- Moving up the value chain

- Service sector development

Key taxes

1 Individual income tax (IIT)

- Lower IIT will result in more disposable income for some workers

2 Environmental tax

- Implementing an environmental tax will discourage polluting activities

3 Resource tax

- A resource tax will increase local government revenue and reduce dependence on land sales

4 Consumption tax

- A consumption tax might be imposed on certain high-energy consuming items

5 Preferential tax regime or tax incentives

- The government intends to support development of Western and Central regions

6 Value added tax (VAT)

- Applying this tax to the service sector is expected to speed up development

Tax law changes: Better wealth distribution

- Individual income tax (IIT) is expected to be subject to major changes during the 5YP. The tax rates for employment income are relatively high while those for capital gains, royalties, and incidental income are relatively low. Such a system potentially imposes a heavy burden on middle-to-low income earners and exacerbates the wealth gap issue.
 - One key change is moving the tax threshold to RMB 3,000 a month, up from the current RMB 2,000, which will exempt more low-income wage earners from paying taxes. According to China International Capital Corp, this change will exempt more than 20 percent of China's labor force from paying income taxes.⁽¹⁾
 - Another change under discussion is a reduction in number of income tax brackets. China's current tax law has nine income brackets with tax rates ranging from 5 percent to 45 percent. According to a recent announcement, the number of brackets could be reduced to seven, after elimination of the 15 percent and 40 percent brackets.⁽²⁾
 - According to Finance Minister Xie Xuren, the tax reform will cost RMB 109 billion in 2011.⁽³⁾ Overhauling IIT could decrease the government's tax revenue, but other factors, such as generally rising wages and higher urbanisation ratio (targeted to rise from 47.5 percent to 51.5 percent), can potentially offset any tax shortfall in the long run. Tax changes will contribute to the government's projected budget deficit of RMB 900 billion in the plan's first year.⁽⁴⁾

Other potential IIT changes

- Recurring income will be calculated and declared on an annual consolidated basis whereas capital income, non-recurring or incidental income will be dealt with on a transaction-by-transaction basis
- A new deduction will be introduced to provide a cost-of-living allowance and specific deductions against certain transactions
- The tax base will be broadened to capture new types of income that may arise from new economic activities
- The current withholding scheme in respect of employment income will be replaced by a scheme of annual self declaration by individuals; conversely, tax on non-recurring income will be subject to withholding at source

Source: Xiao Jie (Commissioner of the State Administration of Taxation); Reform and Improvement of the Tax System

Resource tax reform

- A resource tax is currently levied on production output
- The government plans to change this to a tax based on sales value

Tax law changes: Protecting the environment

- An environmental tax (sometimes referred to as a green tax or carbon tax) might be levied on
 - carbon dioxide from fossil fuels
 - discharges of polluted water.
- Resource taxes will be overhauled during the next five years. This tax has a dual role of (1) raising revenue for local governments and (2) encouraging resource conservation (through higher downstream prices if costs are passed on to end users). This tax was rolled out on a trial basis in China's northwestern region in 2010 and later expanded to 12 provinces. Resource producers in the trial programme were required to pay a 5 percent tax on the sales price of crude oil and natural gas.⁽⁵⁾⁽⁶⁾
 - According to one source, a nationwide resource tax could cut net income at oil majors by around 10 percent.⁽⁷⁾ However, this higher tax charge could be offset by rising oil and gas prices.
 - A resource tax will be an important revenue source for local governments, which now rely on land sales (a dependency that is contributing to bubbles in the property market).
 - Importantly, future resource taxes will be based on sales value, allowing tax revenues to track higher commodity prices.
 - Natural resources subject to a revised tax include oil, gas, and rare earths.

Resource tax changes

Resource	Old tax policy	New tax policy
Crude oil	<ul style="list-style-type: none"> • RMB 8 to RMB 30 per ton 	<ul style="list-style-type: none"> • 5 percent tax on the sales price
Gas	<ul style="list-style-type: none"> • RMB 0.02 to RMB 0.15 per cubic metre 	<ul style="list-style-type: none"> • 5 percent tax on the sales price
Rare earths ^(a)	<ul style="list-style-type: none"> • RMB 0.5 to RMB 3 per ton or cubic metre 	<ul style="list-style-type: none"> • Light rare earths: RMB 60 per ton • Heavier rare earths: RMB 30 per ton

Note: (a) The new resource tax for rare earths became effective on 1 April 2011

Sources: (1) Regulations on Adjusting the Rare Earths Resource Tax, Cai Shui [2011] No.22

(2) Regulations Relating to Resource Tax Reform on Crude Oil and Natural Gas in Xinjiang, Cai Shui [2010] No. 54

(3) Regulations on Several Issues of Crude Oil and Natural Gas Resource Tax Reform in the Western Region, Cai Shui [2010] No. 112

(4) The Ministry of Finance; the State Administration of Taxation





Tax law changes: Economic restructuring

- Value added tax (VAT) reform is also expected. For the past two decades, China has been running parallel indirect tax systems with VAT imposed on the sales of goods, repairs, and processing services; and business tax charged for services (other than repair and processing), transfer of intangible assets, and sales of immovable properties.
 - Whilst the VAT system allows the crediting of input tax against output tax, there is no such credit mechanism under the business tax regime.
 - The service industry, therefore, suffers potentially multiple layers of taxation, which may weaken the global competitiveness of Chinese service companies.
 - VAT rates - which currently stand at 13 percent or 17 percent - may be reduced to lighten the burden of taxpayers.
 - Some service sectors with significant goods input content (e.g. - transportation, construction, telecommunications and leasing) will likely be converted to a VAT regime with a full input tax credit, initially on a pilot basis. In the meantime, other service sectors may be subject to a simplified flat rate VAT system with no input tax credit.
- Corporate income tax (CIT) reform may help small and medium-sized enterprises through preferential tax policies, especially companies involved in conserving energy, reducing emissions, and protecting the environment.
 - Unification of Corporate Income Tax and Foreign Enterprise Income Tax in 2008 created a level playing field for domestic and foreign invested enterprises.
 - According to Premier Wen Jiabao, companies in encouraged business categories in Western regions will enjoy another 10 years of reduced CIT rates.⁽⁸⁾

Comparison of current and anticipated tax measures

Tax	Current tax law	Tax law under discussion
IIT	<ul style="list-style-type: none"> • RMB 2,000 of monthly salary income is tax exempt 	<ul style="list-style-type: none"> • RMB 3,000 of monthly salary income would be tax exempt
Environmental tax	<ul style="list-style-type: none"> • China currently levies a "surcharge" on pollutant emissions 	<ul style="list-style-type: none"> • The "surcharge" will be replaced with environmental taxes
Resource tax	<ul style="list-style-type: none"> • Current resource taxes are based on production output 	<ul style="list-style-type: none"> • Resource taxes expected to be implemented in the next five years will be based on sales value; basing taxes on sales value means that taxes will roughly track rising commodity prices
VAT	<ul style="list-style-type: none"> • Most service firm categories are subject to a business tax (either 3% or 5%) 	<ul style="list-style-type: none"> • Service firms will need to pay VAT instead of a business tax
Consumption tax	<ul style="list-style-type: none"> • A consumption tax, ranging from 1% to 56%, applies to various items such as alcohol, cosmetics, jewellery, and tobacco 	<ul style="list-style-type: none"> • The list of products subject to consumption tax might be adjusted

Sources: (1) Administrative Regulations on Collection and Use of Pollutant Emission Charge, State Council Order No. 369
 (2) Economist Intelligence Unit, China tax regulations, 4 March 2011
 (3) China Daily, Tax breaks aimed at helping service sector, 8 March 2011
 (4) The Economic Observer, 12th Five-Year Plan Promises Big Tax Cuts, 16 Dec 2010

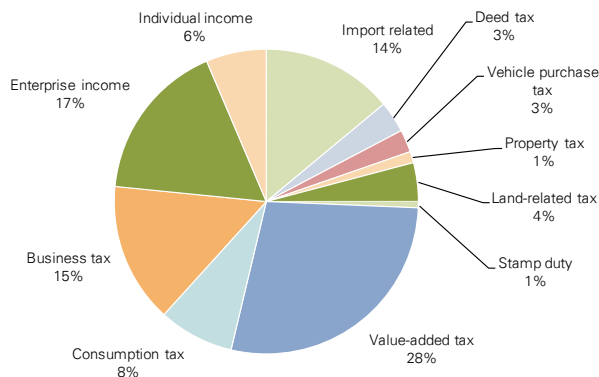
Tax law changes: Guiding the nation's consumption pattern

- **Consumption tax.** The government may adjust the list of items subject to a consumption tax. Currently a consumption tax is levied on 14 consumer products, including alcohol, cosmetics, jewelry, and tobacco. Possible changes to the list include:
 - Additions: may be expanded to cover high-energy-consuming products.⁽⁹⁾
 - Removals: items such as cosmetics might be removed from the consumption tax list, on the grounds that they are now becoming common items instead of luxuries.⁽¹⁰⁾
- **Property taxes** are important to the government's 5YP goal of maintaining pricing stability and hence stability of the nation. Pilot property taxes in Chongqing and Shanghai will serve as models for expansion to other areas.⁽¹¹⁾⁽¹²⁾

Tax trends and opportunities

- The government has discussed building several service outsourcing bases in the next five years; these bases could offer tax incentives and other benefits.⁽¹³⁾
- If environmental taxes are implemented, clean equipment makers could benefit from higher demand.
- The use of CIT incentives to stimulate technology innovation and energy and water conservation is expected to continue. Examples of such measures are:
 - Reduced tax rates for Advanced and New Technology Enterprises
 - CIT exemption on revenue from technology transfer
 - Bonus deduction of R&D expenses
 - Recently promulgated tax holiday for qualified energy-saving service enterprises.⁽¹⁴⁾

Breakdown of China tax revenues (2010)



Note: Rounding may lead to slight discrepancies
Source: China Ministry of Finance (<http://www.mof.gov.cn>)

Impact of tax law changes on the government budget

- China derives a relatively limited amount of revenue from IIT. China's IIT as a percentage of total tax revenue stands between 6 percent and 7 percent. In contrast, the proportion of individual income tax for OECD countries (average) is much higher, standing at 25 percent (2008 figure).⁽¹⁵⁾

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Challenges and risks

- The change of the IIT system will likely pose a challenge to the PRC tax authorities in terms of tax administration and collection.
- Rising inflation could reduce purchasing power, negating the planned benefits of lower IIT.
- Lowering taxable income would help ease the financial strain of those in lower tax brackets, but would have a limited wealth redistribution effect given that many of China's super-wealthy did not amass their fortunes by earning a salary. A few commentators noted that gift taxes and inheritance taxes may be useful tools to promote greater equality.

CEO checklist

- Have you factored a potential environmental tax into your business plan – especially if you operate in or have significant inputs from polluting sectors such as steel, cement or mining?
- Does your company operate in resource-intensive areas such as oil or natural gas which may see changes in resources taxes?
- Are you confident about your China tax strategy for the next five years, including ability to leverage special tax incentives?
- Do you operate in the service sector where tax changes are potentially broader?
- Does your future China “footprint” take into account location-based incentives?

Sources: (1) *China Economic Review*, China tax reform aims to fuel consumption, 14 March 2011
(2) *Amendment to Individual Income Tax Law (Draft for comments)*
(3) *China Daily*, China Tax Changes To Reduce Revenue By CNY109 Bln, 21 April 2011
(4) *National Development and Reform Commission Report*, 5 March 2011
(5) *Regulations Relating to Resource Tax Reform on Crude Oil and Natural Gas in Xinjiang*, Cai Shui [2010] No. 54
(6) *Regulations on Several Issues of Crude Oil and Natural Gas Resource Tax Reform in the Western Region*, Cai Shui [2010] No. 112
(7) Neil Beveridge, *Asia-Pacific Oil & Gas*, 24 Feb 2011, Bernstein & Co.
(8) Premier Wen Jiabao speech at the meeting of the CCP Central Committee and the State Council on Western Development in July 2010
(9) Xiao Jie (Commissioner of the State Administration of Taxation): *Reform and Improvement of the Tax System*
(10) *The Economic Observer*, 12th Five-Year Plan Promises Big Tax Cuts, 16 Dec 2010
(11) *Provisional Measures for the Levying of Real Estate Tax on Certain Residential Properties in Chongqing and Implementation Rules for the Collection and Administration of Real Estate Tax on Certain Residential Properties in Chongqing*, Chongqing Municipal People's Government Order No. 247
(12) *Provisional Measures for the Levying of Real Estate Tax on Certain Residential Properties in Shanghai*, Hu Fu Fa [2011] No. 3
(13) *Xinhua*, China strives to optimize trade structure in next five years, 15 March 2011
(14) *Notice concerning Business Tax, Value Added Tax, and Corporate Income Tax Policies in view of Fostering the Energy-conserving Service Industry*, Cai Shui [2010] No. 110
(15) *OECD Tax Database* (<http://www.oecd.org/>)

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