

Corporate Income Tax computation method

Tax base

a. The taxable items

The taxable items of the Foreign enterprise Income Tax are the income from production, business operations and other income of the taxpayers.

The Income from production and business operations as mentioned above refers to the income derived by the enterprises with foreign investment and foreign enterprises from the production and business operations in manufacturing, mining, communications and transportation, construction and installation, agriculture, forestry, animal husbandry, fishery, water conservancy, commerce, finance, service industry, exploration and exploitation, and in other trades.

Other income as mentioned above covers profit (dividend), interest income, rental income, income from lease or alienation of property, income from provision or transfer of patents, technical know-how, trademark, copyright and other non-business income.

b. The basic formulas for computation of taxable income

The tax base of the Foreign Enterprise Income Tax is the taxable income.

The amount remaining from the gross income of the enterprises with foreign investment and foreign enterprises derived from their in –China institutions and places engaged in production, business operations and other income in a tax year after deduction of the cost, expenses and losses is the taxable income.

The “tax year” as mentioned above starts from January 1 and ends on December 31 under the Gregorian Calendar. The foreign enterprises that have difficulty in computing the taxable income according to the tax year as stipulated in the Tax Law may apply to the local competent tax offices for approval to use its own 12-month fiscal year as the tax year.

The taxpayers commencing its business in the middle of the tax year, or having actually operated for less than 12 months in a tax year due to merging or close-down shall treat the actual operating period as the tax year.

* Manufacturing industry:

$$\text{Taxable income} = \text{Sales profit} + \text{Other business profit} + \text{non-business income} - \text{non-business expenses}$$

$$\text{Sales profit} = \text{Net sales of the products} - \text{Sales cost of products} - \text{Tax on sales of products} - \text{Sales expenses} - \text{Administrative expenses} - \text{Financial expenses}$$

* Commerce:

$$\text{Taxable income} = \text{Sales profit} + \text{Other business profit} + \text{Non-business income} - \text{Non-business expenses}$$

$$\text{Sales profit} = \text{Net sales} - \text{Cost of sales} - \text{Tax on sales} - \text{Sales expenses} - \text{Administrative expenses} - \text{Financial expenses}$$

*Service industry:

$$\text{Taxable income} = \text{Net business income} + \text{Non-business income} - \text{Non-business expenses}$$

$$\text{Net business income} = \text{Gross business income} - \text{Tax on business income} - \text{Business expenses} - \text{Administrative expenses} - \text{Financial expenses}$$

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The taxes listed in the above formulas do not include the price – exclusive VAT at all.

The taxable income for other trades shall be computed with reference to the above formulas.

For foreign air transportation and ocean shipping enterprises engaged in international transportation and shipping business, the taxable income shall be 5% of the gross income generated from transport and shipping services for passengers and cargoes loaded in China.

For foreign enterprises having no establishments or places in China but having from China the income of profits, interest, rental, royalties and other income or for foreign enterprises having establishments or places in China but having the above said income not effectively connected with the establishments or places, the taxable income shall be the total income. In computing the taxable income, the Business Tax paid on the royalties according to Chinese tax laws may be deducted. Among other income, the taxable income shall be the balance of the transfer proceeds after deduction of the original value of the properties for the income derived by foreign enterprise from transfer of such properties as houses, buildings and the attachment, or land use right within China. Where foreign enterprises are unable to provide the justified vouchers for the original value of properties, the local competent tax offices shall appraise the value for them in account of practical situation.

c. Time period for the computation

The taxable income of Foreign Income Tax is computed on the accrual basis.

The income derived by taxpayers from the following business may be computed by period, on which the taxable income shall be calculated:

* For sales of products or commodities by installment payments, the realization of sales revenue may be determined on the date of invoice issuance upon delivery of goods, or the date agreed in the contracts for the purchasers to make payment.

* For constructions, installations, assembling and provision of labor services, which last more than one year, the realization of revenue may be determined according to the progress of the projects or the amount of work completed.

* For processing, manufacturing large machinery equipment and vessels for others consecutively for more than one year, the realization of revenue shall be determined according to the progress or the amount of work completed.

For Sino-foreign co-operative enterprises sharing their products, the time of obtaining the shared products shall be time of revenue realization. The revenue should be valued in line with the sales price to the third party or the market price at that time.

For donations received by the enterprises with foreign investment and foreign enterprises having establishment or places in China (hereinafter under this question called enterprises in short), the following rules should be observed in computing the taxable income:

* The non-monetary donations of assets (including fixed assets, intangible assets and other goods) received by enterprises should be valued at reasonable prices and accounted in relevant asset items. At the same time, it'll be regarded as the income of the current year liable to enterprise income tax. If the donation value is so large that enterprises have difficulty paying the tax in one instance, the value may be on average computed into the taxable income within five years after approval by the local competent tax offices.

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* The monetary donations received by enterprises should be accounted at one instance into the annual income of the current year liable to enterprise income tax.

In addition, the payables of enterprises, which are not requested by the creditors for payment for two years after maturity, should be accounted into the income of the current year and liable to enterprise income tax.

Deductible items

When computing the taxable income for Foreign Enterprise Income Tax, the following items are allowable for deduction:

a. The reasonable interest on borrowings (that is the interest not higher than the commercial loans interest rate) incurred by the taxpayers in relation to production and business operation may be deductible upon approval by the local competent tax offices after examination on the relevant documents provided by the taxpayers.

b. The wages paid by the taxpayers to their employees may be deductible upon approval by the local competent tax offices after examination of the relevant documents submitted by the taxpayers as requested.

The medical insurance, pension insurance (excluding the overseas social insurance of the employees working in China), house reserve fund and the employee education expenses withdrawn by the taxpayers according to the State rules may be deductible. The other welfare expenses of the taxpayers may be deducted on actual basis, but within the limit of 14% of the total deductible wages.

c. Where the technology development expenses incurred in China by the enterprises with foreign investment in the current year is increasing by 10% or more, in addition to the deduction on actual basis, 50% of the actual expenses in technology development of the current year may be deducted from the taxable income of the current year upon approval by the tax department.

The technology development expenses incurred by the foreign enterprises with establishments, place in China engaged in production and business operation may be treated in reference to the above rules.

d. The entertainment expenses on public relation incurred by the taxpayers which are related to production and business operation may be deducted within the following limit upon real records or vouchers:

* For those of net annual sales below 15 million yuan , the limit is 0.5% of the net sales. For those of net annual sales over 15 million yuan, the limit is 0.3% of the net sales.

* For those of annual business revenue below 5 million yuan, the limit is 1% of the business revenue. For those of annual business revenue over 5 million yuan, the limit is 0.5% of the business revenue.

e. The exchange gain or loss incurred in course of preparation and production and business operation should be listed appropriately as profit or loss in the matching period.

f. For practical need, the enterprises with foreign investment and foreign enterprises engaged in credit and leasing business may draw bad debts provisions not more than 3% of the annual balance or outstanding loans or the balance of the receivables at year end. The provisions thus

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drawn is allowed for deduction from the taxable income of the year. Should the accounts receivable have an agreed time limit, that time limit shall be taken as the deadline. The creditors and the accounts receivable for sales on commission that do not expire shall not be withdrawn any bad debt provision.

The excessive part of the actual bad debt loss incurred over the bad debts provision drawn in previous year may be accounted into the losses of the current year. The part of the bad debts provision drawn in previous year over the actual bad debt loss should be computed into the taxable income of the current year.

The receivables having been already listed as losses and recovered entirely or partially in subsequent years should be re-accounted into the taxable income of the year recovering the receivables.

g. The insurance premium expenses of the taxpayers on buying the property, responsibility insurance from the insurance institutions for the purpose of preventing risks may be deducted on actual basis if the expenses are within the insurance scope as ruled by insurance laws and regulations.

h. The net losses of inventory loss, damages and scraps of fixed assets and current assets, the bad debt losses and the abnormal losses resulting from the unexpected events like natural disasters and civil lawsuits (hereinafter referred to as property losses under this question) may be deducted from the taxable income when computing the enterprise income tax for the current period.

The property losses incurred by the foreign enterprises having establishments and places in China engaged in production and business operation may be treated in reference to the above rules.

i. The donations of public benefit and relief nature in China (refers to the donations made through non-profit social organizations or State organs within China to the public beneficial causes like education, red cross and civil affairs and/or to the areas of natural disasters and poor areas. It does not include the donations directly made to the benefiting recipients.) made by the enterprises with foreign investment and foreign investment and foreign enterprises may be entirely deducted from the taxable income.

The funds granted by the enterprises with foreign investment and foreign enterprises through the non-profit social organizations or government within China to un-associated science and research institutes and universities for research and development work may also be deducted entirely from the taxable income.

j. The reasonable overhead expenses paid to the head offices by the foreign enterprises having establishment or places in China that are connected with the establishment or place in China may be deductible upon examination and agreement by the local tax department of the evidential documents provided by the enterprises.

k. The income tax paid overseas on the profits (dividends), interest, rentals, royalties and other income earned outside China by and effectively connected with the establishments or places set up within China by foreign enterprises may usually be deductible (unless otherwise stipulated by the State).

1. Depreciation of fixed assets and amortization of intangible assets (refer to the section for

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tax treatment of fixed assets and intangible assets for details).

Non-deductibles

In computing the taxable income of the enterprises with foreign investment and foreign enterprises, the following spending items are not allowed for deductions (unless otherwise provided by the State):

- a. Spending on the acquisition or construction of fixed assets.
- b. Spending on transfer or development of intangible assets.
- c. Interest on capital.
- d. Various taxes paid on income.
- e. Fines on unlawful operations and losses sustained from confiscated property.
- f. Various interest on late payment of taxes and fines.
- g. The portion of losses from natural calamities or accidents covered by insurance indemnity.
- h. Donations and contributions other than those utilized in China for public welfare or relief purposes.
- i. Royalties paid to the head office.
- j. Other spending items not related to production or business operation.

Treatment of assets

In computing the taxable income, the assets are treated as follows:

a. Fixed assets

The fixed assets mentioned in the Foreign Enterprise Income Tax Law refer to houses, buildings, machines, mechanical apparatus, transportation tools and other equipment, appliances and tools related with production and business operation with useful life more than one year. The articles which are not used mainly as the equipment for production and business operation may be deductible on the basis of actual value used if the value per article is under 2000 yuan or if the useful life is not longer than 2 years.

The valuation of the fixed assets of the enterprises with foreign investment and foreign enterprises should be based on the original cost:

* For the fixed assets purchased, the original cost will be the purchasing price plus freight, installation fees and other relevant expenses incurred before use.

* For the fixed assets self-produced or self-constructed, the original cost will be the actual expenses incurred in course of production or construction of the fixed assets.

* For the fixed assets used for investment, the original cost will be, in consideration of the depreciation, the reasonable price agreed in the contracts or the price appraised in reference with the market price plus the relevant expenses incurred before use.

* The fixed assets received by enterprises as gifts may be properly valued and depreciated.

Where enterprises obtain borrowings for acquisition or construction of fixed assets, the interest on the borrowings prior to the use of the fixed assets should be included in the original cost of the fixed assets.

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For the fixed assets allowable for depreciation, the depreciation should begin from the month following the month when the fixed assets are put into use. For the fixed assets stopping use, the depreciation should stop from the month following the month of the stop.

Before counting the depreciation of the fixed assets, the salvage value should be computed at certain percentage of the original value of the assets (generally not less than 10%) and deducted from the original value of the fixed assets.

The depreciation of fixed assets should usually be computed by straight-line method or by other method. The formulas for the straight-line method are:

$$\begin{aligned}\text{Annual depreciation rate} &= (1 - \text{Expected net residual value}) / \\ &\quad \text{Years for depreciation} * 100\% \\ \text{Monthly depreciation rate} &= \text{Annual depreciation rate} / 12 \\ \text{Monthly depreciation value} &= \text{Original value of the fixed assets} * \\ &\quad \text{Monthly depreciation rate}\end{aligned}$$

The minimum depreciation period is 20 years for houses and buildings, 10 years for machinery and mechanical apparatus and 5 years for electric equipment and automobiles. The useful life for depreciation or amortization of the software purchased by taxpayers may, upon approval by the tax department, be properly shortened to minimum period of 2 years. The shortest useful life for the production equipment of the integrated circuit enterprises is 3 years. In other cases of any need to shorten the period of depreciation on the fixed assets due to special reasons, an application shall be made by the said taxpayers to the competent tax department for approval.

For the used fixed assets obtained by enterprises with a remained useful life shorter than depreciation period specified by tax law, the depreciation may be computed on basis of the remained useful life upon approval by the competent tax department after examination of the application by the taxpayers.

In course of use of the fixed assets, the expenses incurred for value increase due to expansion, replacement, rebuilding and/or technical renovation should be added to the original cost of the fixed assets. Moreover, the depreciation period should be properly prolonged for the fixed assets whose useful life may be prolonged. The computation of depreciation should be adjusted accordingly.

No depreciation shall be allowed for fixed assets that remain in use after the full depreciation period.

In case of transfer or disposal of fixed assets by enterprises, the balance of the proceeds after deduction of the net value to be depreciated, salvage value and the handing fees shall be treated as profit or loss of the current year.

b. Intangible assets

Intangible assets refer to the assets without physical shape that can be used by taxpayers for long time, including patents, trademarks, copyright, land use right, non-patented technology, goodwill.

The value of the intangible assets for the enterprises with foreign investment and foreign enterprises should be based on the original cost:

* The original cost of the intangible assets transferred shall be the actual payment made

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according to reasonable prices.

* The original cost of the intangible assets self-developed shall be the actual expenses incurred in course of development.

* The original cost of the intangible assets for investment shall be the reasonable price agreed in the contracts (or agreements).

The interest on the borrowings by enterprises for transfer and development of intangible assets prior to use of the assets should be included in the original cost of the intangible asset.

Amortization of intangible assets shall be computed by the straight-line method.

Intangible assets for investment or transferred may be amortized according to the agreed useful life, if any, in the contracts (agreements). Intangible assets without such an agreed useful life or self-developed shall be amortized over a period of not less than 10 years.

c. Expenses incurred during the organization period of the enterprises with foreign investment and foreign enterprises should be amortized within minimum of five years from the month following commencement of production or business operation.

Special rules for computing the taxable income

a. For an enterprise with foreign investment investing in another enterprise inside China, the profits (dividends) obtained from the enterprise under investment may be excluded from the taxable income of the said enterprise with foreign investment. But the expenses and losses incurred in the above-mentioned investment shall not be deductible from the taxable income of the said enterprise.

b. Where the taxpayers are unable to provide complete and accurate evidences of costs and expenses and to work out its taxable income correctly, the local competent tax offices shall assess the profit ratio and the taxable income in reference to the profit level of the same or similar trade.

c. Where taxpayers are unable to provide complete and accurate evidences of income and to report its income correctly, the local competent tax offices shall assess the taxable income by using the method of cost (expense) plus reasonable profit.

d. The business transactions between the establishment or set up in China by taxpayers to engage in production or business operations and their associated enterprises should follow the arm's length principle. Where the payment or receipt is not charged in line with this principle and thus having reduced adjustment to the taxable income.

e. The annual losses incurred by the establishments and places set up in China by the enterprises with foreign investment and foreign enterprises may be carried forward to offset the income of the next tax year. If the income of the next tax year is not enough to offset the losses, the losses may be carried forward to the subsequent years with the maximum period of five years.

Example:

One enterprise had losses of 1.7 million yuan and 0.6 million yuan respectively in 1999 and 2000. From 2001 to 2004, the enterprise made profit of 1.6 million yuan without offsetting the losses of 1999 and 2000. thus, by 2004, the losses of 1999 had already carried forward for 5 years by only offsetting 1.6 million yuan. The remaining 100000 yuan should not be carried forward to 2005 for offsetting. The losses of 0.6 million yuan of 2000 may be offset with the profit of 2005. if

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the profit of 2005 was 0.5 million yuan, only 0.5 million yuan might be offset and the remaining 100000 yuan should not be carried forward to 2006 any longer since the 5 years periods had finished.

f. In case that the accounting practice adopted by the establishments or places by the taxpayers to engage in production or business operations contradicts the relevant tax provisions of China, the taxable income should be computed in accordance with the relevant tax provisions of China.

Tax rate and computation of tax payable

The Foreign Enterprise Income Tax adopts flat rate.

The enterprise income tax payable shall be computed on the basis of the taxable income and by applying 30% rate. The local enterprise income tax payable shall be computed on the basis of the taxable income and by applying 3% rate. Thus the aggregate tax rate is 33%.

The foreign enterprises having no establishment or place in China but deriving profits, interest, rental, royalties and other income from sources in China, or those having establishment or place in China but the said income is not effectively connected with such establishment or place, shall pay the income tax of 20% on such income. At present, the income of interest, rental, royalties and other income is taxed at lower rate of 10%.

The formula for computing the tax payable is as follows:

$$\text{Income tax payable} = \text{Taxable income} * \text{Applicable tax rate}$$

Examples:

a. One joint venture has 6 million yuan taxable income for the year, then the income tax payable shall be computed as:

$$\text{Income tax payable} = 6 \text{ million} * 30\% = 1.8 \text{ million yuan}$$

$$\text{Local income tax payable} = 6 \text{ million} * 3\% = 180,000 \text{ yuan}$$

Example 2:

A foreign bank having no establishment or place in China obtained interest income of 10 million yuan from China. The income tax payable shall be computed as:

$$\text{Tax payable} = 10 \text{ million yuan} * 10\% = 1 \text{ million yuan}$$

Example 3:

The China Office of one foreign company has sold, on the company's behalf, one building with the original value of 5 million yuan which belongs to the company and received an income of 10 million yuan and paid relevant taxes and charges of 2 million yuan. Then the income tax payable shall be computed as follows:

$$\begin{aligned} \text{Taxable income} &= 10 \text{ million yuan} - 5 \text{ million yuan} - 2 \text{ million yuan} \\ &= 3 \text{ million yuan} \end{aligned}$$

$$\text{Income tax payable} = 3 \text{ million yuan} * 10\% = 300,000 \text{ yuan}$$

The Foreign Enterprise Income Tax payable shall be computed in terms of Renminbi (RMB). For taxpayers deriving income in foreign currencies, they should convert the income into Renminbi according to the exchange rates quoted by the People's Bank (or the rate worked out according to relevant rules) and then compute and pay the income tax. When pre-paying the

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income tax in quarterly installment, taxpayers should convert the income in foreign currency into Renminbi according to the exchange rates quoted on the last day of the quarter and then pay the income tax. In the final settlement at the end of the tax year, the income tax prepaid in quarterly installments shall not be converted again. Only the balance of the foreign currency income over the whole year on which the tax has not been paid shall be converted into RMB according to the exchange rate quoted on the last day of the year for computing and paying the tax.

In case that any income obtained by the taxpayer is in the form of non-monetary assets or equity, the income shall be computed or assessed with reference to the prevailing market price.

Foreign tax credit

The enterprises with foreign investment that have already paid foreign income tax (excluding the case of obtaining compensation after paying the tax and the tax borne by others for the taxpayers) on their income derived from sources outside China may, when computing the enterprise income tax payable, credit the foreign income tax against their income tax payable. The credit, however, should be limited to the amount of income tax payable computed according to Chinese tax law. This foreign income tax credit limit should be computed on country basis and not on item basis.

The computation formula is as follows:

Foreign income tax credit limit=Total income tax payable computed according to Chinese tax law on world income*Income from sources from a foreign country / Total income from world-wide sources.

The foreign income tax actually paid by the enterprises with foreign investment on their income from outside China may be credited against the income tax payable unless the foreign income tax paid exceeds the limit calculated by the formula above. The excessive part of the foreign income tax over the limit shall neither be allowed for credit against the tax payable nor for deduction from the taxable income. The excessive part, however, may be carried forward to the subsequent years for maximum period of five years.

Example:

A Sino-foreign joint venture obtained a taxable income of 30 million yuan from sources within China and a taxable income of 10 million yuan from the branch set up in country A by the joint venture, and has paid the income tax of 3.6 million yuan in country A. The foreign income tax credit limit and the income tax payable in China are computed as:

a. Credit limit = (30 million yuan + 10 million yuan) * 33% x 10 million yuan / (30 million yuan + 10 million yuan) = 3.3 million yuan

b. Aggregate income tax payable=(30 million yuan, but the credit limit is only 3.3 million yuan. The difference 300,000yuan may only be carried forward to subsequent years for credit.

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