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Comprehensive analysis of developments in tax investigations in China for 2012

Background

Chinese tax authorities regard the Tax Investigation department as an important administrative department for the securing of State tax revenue. Since the 2008 Global Financial Crisis (GFC), the tax authorities have taken prominent steps to strengthen tax investigation. In particular, the tax development plan outlined in China's 12th Five-year Plan explicitly requires strengthening tax investigation and encouraging enhanced tax compliance. This spirit is reflected in the focus of tax investigations in 2012.

In 2011, China's Tax Investigation department focused on tax non-compliance cases, special tax inspections, regional special tax rectifications, inspections of key tax sources and criminal activities related to invoices. Publicly available data indicates that there was a total of 212,000 investigations and prosecutions, with RMB 92.35 billion in taxes, late payment surcharges and penalties recovered for the State treasury.

Focuses in 2012

Key points for national tax investigation work

At the beginning of 2012, the State Administration of Taxation (SAT) issued the 'Key Points for National Tax Investigation Work' in 2012 (Jibianhan [2012] No. 1), which emphasises the work to be done in the following areas:

- **Rectification and regulation of the general tax environment:** includes regular tax inspections, investigation and prosecution of major tax offences, special tax inspections and special regional tax rectifications, inspections of key tax sources and a continuing crackdown on criminal activities related to invoices

- **Law enforcement:** improve the quality of handling tax investigation cases pursuant to laws, strictly apply the 'Separation of Four Functions' system internally in the Tax Investigation department as specified in the Detailed Rules for the Implementation of Tax Collection and Administration Law (i.e. the functions of target location, case investigation, case trial and enforcement shall not be carried out separately outside of the Investigation department), and strengthen the supervision and control of the internal functions of the Tax Investigation departments

- **Modernisation and globalisation of tax investigation:** push forward the tax investigation administration reforms; carry out widespread tax investigation classification administration; spread the application of the 'tax audit work paper model'; enhance the level of information technology in tax investigation; establish and employ a tax investigation case base; conduct research and investigate tax inspections; carry out research and investigative inspections in connection with special tax inspections, specifically of industry business modes, the industry's general scale, and tax compliance in selected hot/new industries and industries with weak tax collection supervision; and improve the reciprocally interactive mechanism for State and local tax investigation cooperation and departmental co-ordination.

The 2012 tax investigation appraisal targets include the following: on average, the investigation targets identified shall be over 90 percent correct nationwide; over 90 percent of cases shall be wound up; more than 90 percent of recovered taxes from tax investigations shall be paid to the treasury; the SAT shall reply to 100 percent of requests for assistance with respect to the cases it has supervised; and the reply shall provide 95 percent of the information requested.

Special tax inspections

In 2012, the SAT will continue carrying out special tax inspections nationwide. The latest tax circular, Guoshuifa [2012] No. 17 (SAT Circular on Carrying out 2012 Special Tax Inspections) puts the tax inspections into three categories: 1) industry-specific tax inspections; 2) region-specific tax inspections; and 3) key source tax inspections.

As in 2011, industry-specific tax inspections will include mandatory and discretionary inspections. The mandatory items will cover: 1) the enterprises issued with special VAT invoices for oil products; 2) projects under capital transactions; and 3) enterprises that claim export tax refunds (exemptions) on exports of electronic products, garments and furniture, and trading companies that undertake export business on behalf of clients. The capital transaction projects listed under the scope of tax inspections not only refer to industrial investments, IPO financing and corporate internal restructuring, but also include mergers and acquisitions (M&A), shareholding alliances, outbound venture capital investments, financial investments and others.

Compared to 2011, the scope of discretionary inspections will expand in 2012. In addition to the required inspections of the real estate, construction and installation industries, high-income earners' individual income tax (IIT), as well as non-resident financial enterprises, local commercial banks and joint stock banks will also be included in the category of 'others for tax inspection'.

With regard to regional-specific tax rectification, the SAT requires all tax authorities to organise and conduct special tax inspections in areas within their respective jurisdictions, focusing on areas with high concentrations of agricultural product processing enterprises or where tax discrepancies and non-compliance are common. The SAT will select key areas to supervise or in which to organise tax investigations directly.

There are 14 large-scale state-owned enterprises (SOEs) and foreign investment enterprises listed as key source enterprises for inspection, covering the steel and iron, transportation, petroleum, coal, automotive and home care chemicals industries.

As in 2011, this year these inspections will begin in March and close end of October 2012, and will cover tax payments for the 2010 and 2011 tax years. Where tax non-compliance is identified, tax inspections can be conducted retroactively. A Special Tax Inspection Notice provides local tax officers with detailed guidance on how to implement a targeted inspection, including approaches to selecting targets, inspection methods and the scope of key inspections.

Tax source survey bulletin of China's key enterprises

In addition to the tax inspection work deployed by the SAT, the Ministry of Finance (MoF) is also carrying out a key tax source survey. According to the Circular of the MoF and the SAT on the 2012 Tax Source Survey Bulletin of China's Key Enterprises (Caishui [2012] No. 29), over 1,000 large-scale SOEs and foreign investment enterprises are being surveyed. The main purpose of the survey is to keep abreast of the dynamic distribution of corporate income tax sources in China, to gather opinions and recommendations on the existing tax policies and to provide a reference for analysing the macro-economy.

The 2012 Tax Source Survey started in the first quarter of 2012. The Financial departments at the provincial levels are required to report data to the MoF relating to a minimum of 60 percent of target enterprises in their jurisdictions within 20 days of the end of the first quarter.

KPMG observations

The Chinese tax authority stresses that when doing key tax inspections, the Tax Investigation department should pay attention to internal and external collaboration. Internally, it should focus on those collaborations with the Tax Collection and Administration departments, state tax bureaus, local tax bureaus and tax authorities in other jurisdictions; and, externally, on those with public security bureau, industry and commerce bureau, procuratorates, courts, customs houses, banks, and so on. The SAT is currently formulating and improving the information sharing mechanism with other government departments. For example, according to the Circular of the SAT and the State Administration of Industry and Commerce (SAIC) on Strengthening the Cooperation of the Tax Authorities and the Industrial & Commercial Administration Departments in Equity Transfer Information Sharing (Guoshuifa [2011] No. 126), the tax authority should be able to easily access the information held by the Industrial and Commercial Administration department relating to equity transactions of listed and non-listed companies. Such information will facilitate the tax authority's in-depth inspection of the equity transactions in question.

One tax investigation approach the Chinese tax authority still frequently employs is using the self-assessment and reporting assessment results from taxpayers. In 2009, during the GFC, 70 large-scale enterprises were required to make self-assessments for tax inspection. Since 2011, self-assessments have been carried out on several levels, including the SAT-designated self-assessment of Sinopec affiliates pursuant to Guoshuihan [2011] No. 69 (the Circular of the SAT on Carrying Out Tax Service and Administration Specifically on Sinopec Affiliates), the self-assessment of enterprises in each jurisdiction deployed by the Tax Management departments of large enterprises based on tax exposure evaluations, as well as some self-assessments of local enterprises designated by the local tax authorities.

Though the purpose of the MoF's enterprise Tax Source Survey is to analyse tax sources, we understand that some local tax authorities might just place the enterprises listed above under 'key tax inspections'.

To improve investigation efficiency, the tax authority is trying more advanced investigation approaches. In 2011, some provincial and municipal tax authorities started a pilot application of the 'tax audit work paper model' for tax investigations of large-scale enterprises. The model uses the work processes of financial audits for reference, analysing electronic data from a tax perspective to strengthen the gathering of financial information. For the time being, the SAT is satisfied with the model as it enables a complete and in-depth inspection of taxes, transactions and specific issues, and can control and supervise the quality and process of the investigations. Such a model is expected to be adopted nationwide in the near future.

Measures

Under the severe situation of strengthening tax investigation, the pressure on taxpayers is unprecedented. The pressure is from the tax authority's deeper understanding of external information and from the proper reporting of self-assessment results. In the meantime, tax investigation methods are continuously improving, with taxpayers being forced to make more detailed and complete disclosures. Local management faces challenges in addressing tax investigations appropriately and solving any tax disputes that arise.

From the taxpayers' perspective, optimised internal tax controls may ease such pressure to some extent. For example, in China, the invoice management system is the core issue of tax collection and administration. In previous years, tax investigation officers have always focused on invoices during tax inspections. There are constantly cases where taxpayers cannot claim expense deductions or where they even have severe penalties imposed simply because of their poor management of invoices. As such, setting up and implementing an invoice system may greatly reduce management risks related to invoices. In general, tax risk control shall focus on the following aspects:

- setting up a complete set of control procedures, listing the control points
- establishing tax standardisation and automation management processes, and risk control processes
- setting up tax risk communication mechanisms
- updating control points regularly and optimising internal management
- establishing a rational and effective internal Tax Management department
- evaluating if there is a rational equilibrium of posts and internal control systems
- evaluating the professional ethics and capability of tax staff
- integrating the tax risk control system and other risk control systems of the enterprise.

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