Oil Taxation in China — Implications for Foreign Companies

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Introduction
China’s “Open Door” policy, launched in 1979, has attracted substantial foreign direct investment (FDI). Foreign investment in the Chinese offshore oil industry represents about 4 per cent of total FDI over the period of 1979 to 1995 (Statistical Yearbook of China, 1983-96). To enhance the tax administration of the industry, in 1982 China established the Offshore Oil Tax Bureau (OOTB) to take charge of tax collection, administration, and audit of enterprises engaged in the co-operative exploitation of Chinese offshore oil resources and the provision of services for the offshore oil projects in China. This paper addresses some concerns about Chinese tax by potential foreign oil companies interested in the co-operative exploitation of China’s natural resources. These concerns include the types of tax to which a foreign oil company is liable, expenses which are deductible in calculating taxable income, areas which are subject to greater scrutiny by the tax authority, and possible tax planning considerations by foreign companies.

Tax Administration
Exploitation of natural resources requires substantial investment and advanced technology. A country’s state of economic and technological development may influence the way in which it exploits its natural resources. China, which presently suffers from a lack of capital and technology, particularly encourages the exploitation of its natural resources in a co-operative form. China started co-operative offshore oil and gas exploitation in 1980, and had signed over a hundred oil contracts and agreements with 59 foreign oil companies from 16 countries and attracted foreign investment of more than US$4.5 billion by the end of 1994 (Almanac of China’s Economy, 1995). More recently, there have been a number of similar contracts signed for the co-operative exploitation of onshore oil and gas fields.

To enhance the tax administration of enterprises engaged in the co-operative exploitation of offshore oil resources, in 1982 China established four OOTBs, directly under the control of the State.
Tax Administration (STA), in order to take charge of tax collection, administration, and audit of offshore oil industries. Oil tax represents an important component of foreign tax administration in China. In 1994 alone, tax revenues from offshore oil industry totalled over US$100 million, representing 2.5 per cent of total foreign tax revenues in that year (China Tax Yearbook, 1995). As the Foreign Income Tax Laws, which became effective on 1 July 1994, consolidated for the first time the special rules that apply to foreign oil companies engaged in the co-operative exploitation of both offshore and onshore oil and gas resources in China, the responsibilities of the OOTB, as set out by the STA, have been widened to cover the onshore oil tax administration.

The jurisdiction of the OOTB covers the following:

- China National Offshore Oil Corporation (CNOOC) and its subsidiaries.

CNOOC is a large Chinese state-owned enterprise established with the purpose of exploring jointly offshore oil and gas resources with foreign companies. China allows CNOOC and its subsidiaries to enjoy the same tax preferential treatment as foreign companies in order to help create a fair environment and to encourage the introduction of advanced technology and the development of offshore natural resources.

- Foreign oil companies engaged in the co-operative exploitation of oil and gas resources in China.

As an oil or gas field does not itself constitute an legal entity, all contracting parties in connection with the co-operative exploitation of China's natural resources must individually fulfill their tax obligations.

- Foreign contractors engaged in engineering projects or the provision of services for oil and gas projects.

The tax liability of a foreign contractor providing technical expertise for oil and gas projects depends on the duration of the services which they render in China.

- Sino-foreign equity joint ventures engaged in providing labour and technical services for oil and gas projects.

Sino-foreign joint ventures providing consultancy, design, supervision, and inspection services for oil and gas projects are liable to comprehensive tax liabilities in China.

**Tax Liabilities**

Foreign oil companies engaged in the co-operative exploitation of oil and gas resources are liable to various taxes including value added tax (VAT), specific royalties, and enterprise income tax.

- **VAT**

VAT is levied in kind on payments received for services performed at a rate of 3 per cent or 5 per cent (depending on the kind of services rendered), and on the actual production of oil (or gas) at 5 per cent.

- **Specific Royalties (Mine District Use Fees)**

From 1 January 1989 a specific royalty on offshore and onshore crude oil and gas is cal-
calculated and paid in kind on the basis of the
annual gross production of each oil or gas
within the contract area. The rates of crude
oil and gas royalties are listed in Table 1.

Table 1: Offshore/Onshore Crude Oil and Gas Royalties

<table>
<thead>
<tr>
<th>Offshore (effective 1 January, 1989)</th>
<th>Rate</th>
<th>Onshore (effective 1 January, 1990)</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Crude oil</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Annual gross production</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>up to 1,000,000 tons</td>
<td>exempt</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1,000,001 - 1,500,000</td>
<td>4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1,500,001 - 2,000,000</td>
<td>6</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2,000,001 - 3,000,000</td>
<td>8</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3,000,001 - 4,000,000</td>
<td>10</td>
<td></td>
<td></td>
</tr>
<tr>
<td>over 4,000,000</td>
<td>12.5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Natural gas</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Annual gross production</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>up to 2,000 million cubic metres</td>
<td>exempt</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2,000 - 3,500 million</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3,500 - 5,000 million</td>
<td>2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>over 5,000 million</td>
<td>3</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

• Enterprise Income Tax

The taxable income of a foreign oil company
shall be the net income in a tax year after
deduction of costs, expenses and losses in
that year. The income tax rate is 30 per cent.
In addition, a local surtax of 10 per cent of
the assessed income tax is levied.

Tax Base

Income items include those arising from the re-
cover of exploration, exploitation, development
expenditure, interest incurred during exploitatio
phase, share of crude oil, and other income. For-
eign oil companies engaged in co-operative oil
exploitation are considered to receive income
when they receive their share of crude oil, and
the amount of their income is computed using
crude oil prices which are regularly adjusted with
reference to the international market price of crude
oil of equal quality.

The Chinese tax regulations do not list items
which are deductible in calculating taxable in-
come, but instead list a number of non-deductible
items. It is important to distinguish between capi-
tal and revenue expenditure so that income tax is properly assessed. The Income Tax Law stipulates that all reasonable exploration expenses incurred by foreign oil companies in exploiting oil or gas resources, regardless of whether they are tangible or intangible assets, may be counted as capital expenditure and amortized from the revenues derived from any oil or gas field that has gone into production for commercial purposes; however, the time limit for this amortization may not be less than one year². All investments in the development stage are treated as capital expenditure with the oil or gas field as a unit, and depreciation is calculated starting from the moment when the oil or gas field enters into commercial production. The depreciation period may not be less than six years³.

Items which are non-deductible in calculating income tax include expenditure on the purchase or construction of machinery equipment, building facilities and other fixed assets; expenditure on the purchase of intangible assets; income tax and overdue tax payments; penalties for illegal operations and losses in the form of confiscated property; donations and contributions other than those for public welfare and relief purposes; royalties paid to head offices; and other expenses that are not related to production and business operations⁴. The Chinese tax laws also limit the deduction of certain expenses. These include:

- **Interest on Equity (Registered Capital)**

  The total amount of investment includes equity and debt. Interest on corporate debt is normally deductible, but interest on equity is non-deductible. The composition of the investment, i.e. the debt/equity ratio, therefore affects tax liabilities. The ratio between the equity and the total amount of investment must comply with the following scheme:

<table>
<thead>
<tr>
<th>Total investment</th>
<th>Equity/Total investment ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>up to US$3 million</td>
<td>7:10</td>
</tr>
<tr>
<td>US$3 million to US$10 million</td>
<td>at least 1:2</td>
</tr>
<tr>
<td>US$10 million to US$30 million</td>
<td>at least 2:5</td>
</tr>
<tr>
<td>more than US$30 million</td>
<td>at least 1:3</td>
</tr>
</tbody>
</table>

- **Management Fee Paid to Affiliated Company**

  Management fees paid to a head office by an establishment in China are deductible if the fees are reasonable and relate to the production or business operations of the establishment. However, the tax laws prohibit a taxpayer from deducting as expenses management fees paid to its affiliates.

- **Foreign Social Insurance**

  Under the tax regulations, payments to foreign social insurance plans on behalf of an employee working in China are not deductible.

- **Entertainment Expenses**

  Entertainment expenses related to business operations are generally deductible, with the following limitations⁵:

<table>
<thead>
<tr>
<th>Annual net sales</th>
<th>Entertainment expenses allowed</th>
</tr>
</thead>
<tbody>
<tr>
<td>up to RMB 15 million</td>
<td>0.5 per cent</td>
</tr>
<tr>
<td>more than RMB 15 million</td>
<td>additional 0.3 per cent of annual net sales exceeding RMB 15 million</td>
</tr>
</tbody>
</table>
Due to the high risk involved in oil and gas exploration, the Chinese tax laws allow a special deduction of losses incurred on a project from income derived from other projects, or from a subsequent project, of the same taxpayer. For example, a foreign oil company engaged in the exploitation of two or more contract areas can deduct losses of a terminated area from revenue of other areas. Moreover, if a foreign oil company terminates its operations in a designated contract area because no commercial oil or gas is discovered, and that company has neither consecutive contracts for the exploitation of other fields nor maintains in China an operation and management establishment or an office, losses incurred in the terminated contract area may be carried forward if the company enters a new cooperative exploration contract within 10 years of the date of termination of the first contract. In this case, the company is allowed to carry forward the losses incurred against future revenues derived from the new contract areas. Carry forwards are generally granted for five years, and the losses incurred are subject to the tax authorities’ review and confirmation.

**Anti-Tax Evasion and Tax Audits**

Anti-tax evasion has been a major headache for the tax authorities. Of all types of company which are under the jurisdiction of the OOTB, foreign contractors who do not have any permanent establishment in China are subject to greater tax scrutiny, because their tracks are more difficult to trace. In order to minimize tax fraud, the OOTB has implemented the following tax measures:

- **Tax Registration**

  Foreign contractors engaged in engineering projects or the provision of services in China must register with the local tax authorities.

- **Deemed Income Treatment**

  Where the company has no establishment in China and is unable to submit complete accounting records for tax assessment, the taxable income of a foreign contractor engaged in contracting projects for exploring and developing natural resources is calculated according to an estimated profit rate determined in relation to its gross income from the contract. To facilitate implementation, the taxable income is deemed to be 10 per cent of gross income from the contract.

- **Tax Withholding**

  When subcontracting part of its engineering projects or labour services to a third party, foreign contractors are required to withhold VAT and/or enterprise income tax, based on the subcontracted amount, on behalf of tax authorities.

- **Contract Reporting**

  When signing a subcontract with a third party, a contractor is required, within 15 days of signing the subcontract, to report the name of the subcontractor, its address, the contract period, and details of the contracted item and contracted amount to the tax authorities for taxability determination.

- **Tax Warranty Deposit**

  A foreign subcontractor with no business licence in China is required to make a tax warranty deposit with the tax bureau. The deposit, generally 10 per cent of subcontracted amount, is to be withheld by the contractor when making payments, and shall be handed
over to the tax authorities for final settlement with the subcontractor.

Despite various anti-tax evasion and avoidance measures taken by the authorities, tax fraud is not rare. Each year the authorities spend considerable time on the tax audits of enterprises engaged in the co-operative exploitation of China's natural resources and the provision of services for oil and gas projects. The areas which are given particular attention by the tax authority when conducting income tax audits on foreign oil companies in China are outlined below.

A foreign oil company engaged in the co-operative exploitation of China's natural resources has to bear the sole risk of being unable to discover a commercially exploitable oil or gas field, i.e. it has to absorb all exploration expenses. China will share the investment expenses with the foreign oil company only at the exploitation and development stages. A joint account is generally set up to account for all expenses incurred by all contracting parties which can be recovered directly from any revenue derived from an oil or gas field going into commercial production. Any other expenses incurred by individual contracting party that cannot be charged into the joint account are put into each contracting party's proprietary account. The nature of production, distribution, and the sales of co-operative oil (gas) fields all mean that the enterprise income tax audit is a two-step process, involving firstly the joint account audit, with the purpose of ensuring the reasonableness of expenses incurred and the deductibility of these expenses for tax liabilities; and secondly the proprietary account audit, with the objective of determining the correctness of enterprise income tax reported by each participant. Table 2 (p. 43) outlines the contents of offshore oil tax audits.

Since most of the oil and gas fields have not yet come to the stage of commercial production, the focus of the tax audit has been on the determination of the reasonableness and deductibility of exploration and exploitation expenses for tax purposes. Requests for adjustments by the tax authority are often made on the following areas:

- Capital expenditure should be depreciated and the depreciation rules should be applied according to the relevant tax regulations.

- Interest payments on a loan incurred by an investor to obtain funds for its capital contribution to an oil (gas) field should not be treated as a cost and expense (i.e. these should be born by the investor itself).

- Interest expenses (other than the second point) are deductible in calculating income if they are incurred in connection with the business activities of the taxpayer and the amount of the interest is reasonable. An interest payment is considered reasonable if the interest rate is not higher than the rate applicable to ordinary commercial loans.

- Purchases and sales, provision of services, and leasing between affiliates should be charged at arm's length price, i.e. the price charged between independent enterprises.

- Royalties paid to head office may not be listed as costs and expenses on the grounds that the branch and head office are the same legal entity.
Table 2: Content of Oil Tax Audits

<table>
<thead>
<tr>
<th>Audit Items</th>
<th>Audit Requirements</th>
<th>Audit Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Income Items</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Recoveries of</td>
<td>Crude oil quantity, price, total amount agreed with those recorded in joint account.</td>
<td>Price to be referenced to the international market price of crude oil of equal quality.</td>
</tr>
<tr>
<td>- exploration expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- exploitation expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- production expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Recovery of interest incurred in exploitation stage</td>
<td>Revenue to be reported in the joint account in the period in which it is received.</td>
<td>Income to be recognised in the period in which share of crude oil is received.</td>
</tr>
<tr>
<td>Proceeds from share of crude oil</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Expense Items</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expenses - exploration</td>
<td>Exploration, exploitation and production expenses to be adjusted based on the joint account audit. Depreciation and amortization period to be agreed with tax regulations.</td>
<td>The depreciation period for exploration expenses and for exploitation expenses not to be less than one year and six years, respectively.</td>
</tr>
<tr>
<td>- exploitation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- production</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pre-contract expenses</td>
<td>Expense to be reasonable.</td>
<td>Pre-contract expenses to be treated as exploration expenses and minimum depreciation period is one year.</td>
</tr>
<tr>
<td>Interest in exploitation stage</td>
<td>Interest to be reasonable.</td>
<td>Normal loan at reasonable interest rates.</td>
</tr>
<tr>
<td>Personnel expenses</td>
<td>Expenses to be reasonable and personal income tax to be paid.</td>
<td>90-day, 183-day, and one-year tax rules to be applied.</td>
</tr>
<tr>
<td>Other expenses</td>
<td>Expenses to be reasonable. Capital expenditure and income expenses to be distinguished.</td>
<td>Expenses to be relevant to production and business operation. Exploration and exploitation expenditures to be capitalized.</td>
</tr>
</tbody>
</table>

- Management fees paid to affiliate(s) may not be listed as costs and expenses because they are two legal entities.

- Pension, retirement pay, accident insurance, injury and disability insurance, and medical insurance may be listed as costs and expenses. However, social insurance, unemployment insurance, life insurance and savings plans may not be counted as costs and expenses.
Tax Planning

- Total Investment Composition

A foreign investment enterprise that borrows money for its capital contribution to a project is subject to the “thin-capitalization” restrictions on interest deductibility. China sets a ceiling for debt-to-total investment ratio. When the ceiling for debt is exceeded, the corresponding interest is not deductible. This rule has the advantage of simplicity in comparison to the rules prevailing in some other jurisdictions such as the United States, but suffers from arbitrariness. For example, the maximum debt-to-total investment ratio for total investment up to US$3 million of 3:10 takes no account of differences in typical leverage between various industries. This means that firms in various industries can have capitalization up to the legal ceiling and that tax saving (S) can be:

\[ S = IC(F - W) \]

Where \( IC \) is the interest charge

\( F \) is the full enterprise income tax rate

\( W \) is the withholding tax rate

- Service Charge Rate and Component

In general, technical and labour services provided to the establishment in China by its parent company and affiliates are charged on a daily rate basis. This daily rate generally consists of employee’s basic salary and wages, allowances, expatriate premium, bonus and fringe benefits such as social insurance. In China, fringe benefits that are either provided by the employer directly or provided on an actual reimbursement basis, backed up by proper receipts, are non-taxable. Obviously, by overpricing the daily rate, the employer can repatriate part of the profit without paying withholding tax. Moreover, the component and composition of the daily rate may influence the employer’s PRC enterprise income tax and employee’s PRC personal income tax. If properly structured, a transfer pricing scheme may be arranged and both the employer’s and employee’s PRC tax burden may be minimized.

- Overhead Expense Allocation

The Chinese tax laws stipulate that reasonable overhead expenses which are relevant to production and operation and paid by a foreign company to its head office may be listed as expenses. There is, however, no restriction on how overhead expenses are allocated. Overhead expenses may be apportioned between a foreign company and its head office, based on a flat rate according to the contract, or on total assets, gross sales, gross profit, capital employed, employee numbers, etc. A foreign company can make tax savings by employing the most appropriate method of overhead expense allocation.

- Engineering Contract Splitting

Among the agreements signed between China and contracting states for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, it is generally provided that a building site, construction, installation or assembly project will be taxed only when such activities continue for a period of more than six months. If the duration is less than six months, enterprise income tax shall not be levied. This is an
area for tax planning for foreign contractors working in the Chinese offshore territory. A project lasting more than six months may be split into several subcontracts, each of which lasts less than six months and is signed with subsidiaries of the company. If properly structured, a split contract arrangement may avoid PRC enterprise income tax on income derived from offshore services.

- Contract Amount Decomposition

With respect to the machinery, equipment or construction materials that are purchased or manufactured by the subcontractor for and on behalf of the foreign contractor to meet the requirement of the engineering or labour service project, the cost of this equipment or materials can be deducted from the total contract sum in calculating the enterprise income tax. The maximum deductible amount is 70 per cent of the total contract sum. The composition of service fee and cost of machinery equipment or construction materials, according to the contract, therefore affects tax liabilities. The higher the cost of equipment, the lower the tax liability. This saving (S) can be:

\[ S = CS(C - P)TR \]

Where

- \( CS \) is the contract sum
- \( C \) is the maximum percentage of equipment cost over the contract sum
- \( P \) is the actual percentage of equipment cost over the contract sum
- \( TR \) is the tax rate

It should be noted, however, that the composition should be commercially realistic and reasonable with respect to the amount of service fees received. Moreover, a foreign contractor may decompose a contract which includes supplying for both labour and materials into two contracts (one for labour supply and the other for material supply) and sign the contracts by two companies within the group company. In this case, the material supply contract results in no tax liability.

**Conclusions**

China established the OOTB to take charge of the tax collection, administration and audit of enterprises engaged in the co-operative exploitation of China’s natural resources. Oil tax represents an important aspect of foreign tax administration in China. A foreign oil company engaged in the co-operative oil or gas business in China is liable to VAT, specific royalties and enterprise income tax. In determining the taxable income, China lists a number of non-deductible expenses and the tax audit work carried out has been generally focused on the reasonableness and deductibility of expenses. To prevent tax fraud, the tax authority has implemented a number of measures including tax registration, tax withholding and tax warranty deposit. Nevertheless, there are a number of areas that foreign oil companies and contractors may consider for tax planning. The use of splitting the contract and contract amount appears most feasible under the current Chinese tax regime.

**Endnotes**

1. Article 12, detailed rules for the implementation of the Income Tax Law Concerning Enterprise with Foreign Investment and Foreign Enterprise (ITL).
2. Article 48 of the ITL.

3. Article 36 of the ITL.

4. Article 19 of the ITL.

5. Article 22 of the ITL.

6. Article 48 of the ITL.

References


Detailed rules for the implementation of the Income Tax Law Concerning Enterprise with Foreign Investment and Foreign Enterprise.

The Income Tax Law Concerning Enterprise with Foreign Investment and Foreign Enterprise.