



Q&A: Chinese income tax on foreign transportation companies

China introduced from August last year a new regulation on income tax which repealed previous measures and brings about some major changes. It broadens the range of foreign transportation companies finding themselves liable for Chinese enterprise income tax; it formally puts tax withholding duties in the hands of charterers and customers; and it significantly increases applicable tax rates. Its aim was to formulate, standardise and remove confusion surrounding corporate income taxation of foreign transportation companies - whether this is the case remains to be seen.

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The new regulation is found in the *Notice on Provisional Measures on the Collection of Tax on Non-Resident Taxpayers Engaged in International Transportation Business* [2014] No.37 (*the Measures*). The Measures provide that non-resident companies conducting international transportation business in China and receiving income from charter hire, freight, stevedoring services and warehousing, are required to pay Enterprise Income Tax (EIT). Since the Measures were introduced shipowners and charterers have consulted us on a number of issues, which are summarised in this article.

1. What is the scope of the Enterprise Income Tax (EIT)? A Non-Resident Taxpayer (NRT) is liable to pay EIT when engaging in the provision of services for the international transportation of passengers and commodities in and out of China, using its own, chartered or slot-chartered vessels, including services such as stevedoring and warehousing.

Previously a NRT was liable for EIT on profits earned from services originating from China to overseas - now income earned from transportation services both out and *into* China are liable.

The former rules were unclear about taxation of income from time charters but the Measures clarify that both voyage and time charter hire are subject to EIT. In contrast, income from demise charters and container leasing is expressly exempted from the scope of the Measures and is subject to the old rules.

2. Who is a Non-Resident Taxpayer? A NRT is a company which:

- is incorporated outside of China in accordance with foreign laws;
- has its actual administrative institution outside China; and
- which may or may not have its institutions or establishments in China.

Therefore, most shipowning companies which are incorporated outside China will be an NRT.

3. How is taxable income from time charter hire calculated and what is the rate of tax? The regulation does not specify how taxable income from time charter hire should be calculated. This is one of several practical questions which needs to be clarified. In many cases, Members and clients will be best advised to seek specialist tax advice.

Allowance is made for expenses which are actually and reasonably incurred during the course of the business, such as running costs, crew costs, port costs and bunkers. These may be deducted from the total income to give the taxable income. However, they must be fully documented and an upper limit may be set for certain types of expense.

If an NRT cannot or does not accurately ascertain its taxable income, the Chinese tax authority will conduct an assessment and make an estimate. It will apply a *deemed profit rate* of no less than 15% and EIT will be calculated on the assessed income. Previously, the *deemed profit rate* was set at 5% of the total income earned for carrying cargo or passengers from China.

The applicable tax rate for an NRT may be 10% or 25% depending on the nature of the taxable income and the method by which the tax is collected. Most foreign shipowners probably face a rate of 10% of net hire income if properly declared. But foreign owners with foreign representative offices in China will probably be paying the full 25% of net hire. By contrast, income of a foreign shipowner from a demise charter to a Chinese entity, would probably be taxed at only 10%.

4. Where should the tax declaration be filed? The tax declaration is to be filed with the tax authority in the place where the NRT carries on its qualifying business, such as a Chinese port of call. The Measures provide that the NRT must either register itself or appoint an agent to register on its behalf within 30 days of either concluding the qualifying business, such as the fixing of a charterparty, or receiving approval of the NRT's business licence. Copies of the

business license and relevant agreements, together with contact details of the local resident representative or agent, need to be provided in order to register.

If the NRT operates at multiple locations/ports in China, it may choose one place at which to complete its tax registration for all ports of call. However, it must file copies of its registration certificate and documents with the other local tax authorities where the NRT has business in China.

5. How is the tax collected?

- Declaration and payment by the NRT

After self-registration (see point 4 above), the NRT must keep records of its business accounts and tax payments for inspection by the Chinese tax authorities. Tax is to be calculated and declared (see point 3 above) and paid monthly or quarterly.

- At source by a withholding agent

If an NRT fails to register and pay tax voluntarily, the tax authorities can appoint a Chinese party, which is making contractual payments to an NRT, as the withholding agent. The withholding agent is required to deduct the tax before making payment to the NRT and to pay it to the tax authorities.

Since withholding agents do not usually have the necessary information or documents for accurate calculation of income and expenses, the tax authority will apply the assessment method (see point 3 above) using a profit rate of not less than 15 per cent to calculate the NRT's taxable income.

6. Can EIT be reduced or waived in accordance with tax exemption treaties? Certain countries have a bilateral tax treaty with China as a means of avoiding double taxation. Generally speaking, if an NRT is incorporated in a country, or has its effective managing office in a country, which benefits from a treaty, it may under the new regulation, apply for an exemption from EIT. The tax exemption is not automatic – there is a strict procedure to follow. The NRT must file:

- its application to the Chinese tax authority with supporting documents to prove business registration in the home State (tax residence certificate);
- relevant transportation agreements to which it is a party, such as a charterparty; and
- any other necessary documents to prove its entitlement to the benefits under the tax treaties as required by the Chinese tax authority.

See the [list of countries](#) which have signed tax exemption treaties with China.

7. Will an NRT entitled to a tax exemption be required to first pay the tax in full and then apply for a tax refund? An NRT can enjoy the benefit of the tax treaty by making an application to its local tax authority. This would result in the company not needing to first pay the full tax and thereafter apply for tax refund. If a company has not applied for the tax exemption and has paid tax to the Chinese tax authority in full, it may apply for a tax refund within three years of payment.

8. Are there other Chinese taxes applying to international transportation business? China has generally tightened up regulation of taxation for this sector, which should be kept in mind when negotiating business deals involving China. In addition to EIT, transactions may also attract value added tax (VAT). From 1 August 2013 transportation activities also fall within the scope of Chinese VAT at a standard rate of 11%, or 17%, depending on the type of service performed within China, or a simplified rate of 3%. VAT is calculated on the basis of gross rather than net revenue.

9. Is there a protective clause which owners can consider using in charterparties? When negotiating contracts with China-based counterparties, it is advisable to agree on liability for EIT and VAT in order to avoid future disputes that may arise. For example, owners would probably wish to include express provisions requiring charterers to accept liability for all Chinese taxes. However, charterers will want to impose surcharges to cover withheld taxes, so charterers will want to negotiate charter clauses to shift the burden for the increased cost to the charterer.

The following *owner-friendly* protective clause has been seen in use:

Charterers shall remain responsible for all PRC Enterprise Income Tax or similar taxes or duties for which owners may become liable in connection with this charterparty and charterers shall hold harmless and indemnify owners in full in respect thereof. Charterers shall not make any deductions from hire/freight or other payments due to owners in respect of such taxes/duties.

Charterers, at owners' option, shall act as owners' fiscal agents with local tax authorities and charterers shall pay such taxes/ duties promptly within the timeframe required by the authorities. Charterers shall provide all necessary documentation to owners to confirm that any such taxes /duties have been settled in accordance with local law. Charterers shall indemnify and hold owners harmless for any liabilities losses and expenses arising due to non or late payment or administrative or clerical error.

Challenges The Measures are in their infancy but there is scope for uncertainty surrounding both their application and enforcement. A number of unanswered questions remain:

- How will income be treated from long-term time charters under which the ship occasionally calls at Chinese ports?
- Does the tax apply if a foreign owner charters to a Chinese charterer but the vessel sails only between foreign ports?
- When both the shipowner and charterer are outside China but the vessel calls at Chinese ports, how will China enforce the Measures and collect the tax?
- How will chartering chains be treated — will only the income from the last subcharter or all the charters up to head owner be taxed?
- Does a non-Chinese shipowner delivering goods to Chinese ports on behalf of non-Chinese customers fall subject to the Measures?
- Will different local tax authorities apply the Measures differently?
- To what extent will the tax authorities in China more rigorously enforce the provisions of the existing laws?

It would be prudent for Members and clients, which are possibly subject to the Measures, to seek specialist tax advice on their potential exposure to Chinese taxes, in particular whether any exemptions apply and whether the terms of the contracts with third parties already make provision for which party is to bear liability for Chinese taxes. In addition, NRTs should register with the Chinese tax authority and ensure they are in compliance with the payment provisions of EIT under Chinese law.

Given the unsettled questions of interpretation, collection and enforcement of the tax, the actual tax burden from calling at Chinese ports may remain unknown for some time.

See the [PRC State Administration of Taxation](#) for further information.

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