INTERNATIONAL TAX REVIEW

China: An overview of taxation of oil and gas in China

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Andrew Zhu and Amy Lo, of Deloitte in Beijing, analyse the tax trends in China's oil and gas sector.

The oil and gas sector, an exciting yet complex industry, continues to undergo significant changes, such as technological development and resource discoveries. For China, demand for energy in the past decade has surged with its fast economic growth. It has been known as a consuming black hole for energy imports all over the world.

Through its new twelfth five year economic development plan, China is on its way to changing that reputation to containment of importation and encouragement for domestic production with government planned investment in upstream oil and gas industry and energy infrastructure to meet the economy's expanding energy demand.

This includes the building of a large scale oil and gas producing base and the development of the natural gas sector including shale gas. The Ministry of Land and Resources in China recently announced in February that China discovered 1.37 billion tonnes of proven geological oil reserves in 2011, up 20.6% from 2010.

This was the ninth year for China to see new oil reserves rise by more than 1 billion tonnes since the founding of the People's Republic of China in 1949. New technically recoverable oil reserves totalled 266 million tonnes, up 21.4% from 2010.

China also discovered new reserves, a rise of 29.6% to reach 765.95 billion cubic metres (bcm), of proven geological natural gas deposits, and new technically recoverable gas deposits amounted to 395.69 bcm, up 37.6%.

Officials did not specify the country's remaining proven oil and gas reserves that are technically recoverable or commercially viable and China has strict definitions in respect of expected production from oil fields over the life of a mine and often differs from the Western countries.

The Chinese government encourages, yet regulates and protects according to law, the cooperative exploration activities of foreign enterprises in the oil and gas industry. Foreign investments, for example Sino-foreign cooperative joint venture projects, Sino-foreign contractual joint venture projects, or wholly foreign-invested projects, in China's extraction of petroleum and natural gas industry have been trending upwards with newly established projects from 2006 to 2009 based on published statistics.

Actual utilised foreign capital for newly established projects was up by 253.73% compared with 2008 and reached $188.75 million in 2009. There was only an increase of 25.73% in 2008. And by countries or regions that newly set up enterprises in China, such as the US or the Asian countries including Hong Kong, Macau, Taiwan, Japan, Philippines, Thailand, Malaysia, Singapore, Indonesia, and Korea, the actual utilised foreign capital was up by more than 200% in 2009, a significant increase compared with that of 2008 for the US and for the Asian countries.

There has also been a marked increase in Chinese outbound energy and resource investments in the past decade to endeavour sustained supply in the long term, with a surge in Chinese outbound mergers and acquisitions activities in 2010, which softened somewhat in the first half of 2011 with investors exercising price discipline, but lower mid-market acquisitions continue to rise.

A recent increased focus on oil and gas, coal related and other energy deal activity is also seen and expected to increase, shifting away from outbound acquisitions in the mining sector that typically denominates overseas energy and resource investments.

While outbound activities into North America and Europe continue to rise and Australia remains steady, more investors in search of quality assets are also looking to other remote areas such as Mongolia, South America, or Africa to secure supply.

This article outlines this brief industry trend with the tax regimes in China focusing on the oil and gas industry, and the common forms of investment into China that are often part of the planning in mergers and acquisitions.

Taxation in China

An overview of the selective tax regimes in China applicable to the oil and gas industry are described below:

Enterprise Income Tax

All enterprises earning income within the territory of China are subject to an income tax rate of 25% on their taxable income, pursuant to the Enterprise Income Tax Law that came into effect on January 1 2008.

Where a foreign enterprise was incorporated outside China, has establishment in China, and engages in production or business operations, that foreign enterprise is subject to income tax for income effectively connected with its establishment in China.

Taxable income is generally defined as its revenue less deductible expenses and/or tax losses. For oil and gas enterprises, deductible expenses may include reasonable production and operating expenses, tax amortization of exploration expenditures, tax amortization of development expenditures, and reasonable overheads. Certain investment incentives surrounding qualified research and development may be available.

Value added tax (VAT)

A taxpayer that engages in the sale or importation of goods (goods include machinery or equipment as well as electricity, heat, gas), or provision of processing, repair, or replacement services within the territory of China, shall calculate VAT payable on the amount received from the sale of goods or taxable services by applying a given tax rate, generally at a standard rate of 17%.

Sino-foreign cooperative exploitation of crude oil and natural gas is subject to VAT at the applicable tax rate of 5% on gross sales. The VAT shall be paid in kind and the basis for computing such tax is generally the gross production after deducting the amount of oil used for operation and depletion. The Chinese party that participates in the cooperative is responsible for matters concerning declaration of VAT or applicable filings to the competent tax authorities.

Consumption tax

Consumption tax is generally levied on taxpayers who manufacture, import, sell, or commission the processing of taxable consumer goods within the territory of China.

Producers or importers may normally shift the tax burden to end-consumers although such tax is collected when goods were sold or imported. Taxable consumer goods are prescribed and include processed oils, which are specifically defined, such as diesel oil or taxable petrol that includes ethanol gasoline.

Processed oils that are produced by an oil producing enterprise but consumed as fuel or raw material during production are generally exempt from consumption tax effective from January 1 2009, while consumption tax is still levied on processed oils for commercial sales.

A refund of consumption tax levied may be available effective from January 1 2009, when (i) an oil/gas field enterprise internally purchased processed oil from a related/group company, (ii) the oil producing enterprise that produced such processed oil is in the same group as the oil/gas field enterprise, and (iii) the oil purchased shall be consumed as fuel or power (other than for transportation) during prospecting or drilling operations and exploitation.

Resource tax

Enterprises that extract mineral products within the territory of China are liable to pay resource tax under the Provisional Regulations of Resource Tax made in 1993.

Mineral products include crude oil and natural gas. A reform of the oil and gas resource tax regime was undertaken in 2011, with the State Council issued amendments to the Provisional Regulations of Resource Tax (the new regulations), and to the regulations of Sino-foreign Cooperative Joint Ventures exploiting onshore and offshore oil resources.

A fundamental change is to base a levy on selling price rather than production volume of crude oil and natural gas, with tax rates ranging from 5% to 10%. A Sino-foreign Cooperative Joint Venture is a specific form of joint participation with a Chinese partner in exploitation, development, or production of resources in China and this will be further described under the next section titled "Investment into China".

The reform was first progressively implemented with pilot schemes for specific regions and subsequently a nationwide rollout came into effect on November 1 2011. A pilot scheme was first instituted specifically for Xinjiang with an effective date of June 1 2010, and a tax rate of 5% levied on selling price of crude oil and natural gas.

The Chinese government in its effort to further develop the Western region then extended the pilot scheme, similarly with a tax rate of 5% levied on selling price of crude oil and natural gas but effective from December 1 2010, to cover the entire Western region. This encompasses 12 western provinces and cities including Chongqing, Sichuan, Guizhou, Yunnan, Shaanxi, Gansu, Ningxia, Qinghai, Xinjiang, Inner Mongolia, Guangxi, and Hubei.

Under that pronouncement, Sino-foreign oil and gas exploitation projects located inside the China Western region that were signed before the effective date would still follow the existing mining royalty regime, which is described further in the next section. Those participating in projects entered into on or after that time will pay resource tax.

The oil and gas resource tax reform was finally rolled out nationwide for those other than the regions under previous pilot schemes, with an effective date of November 1 2011, and tax rates ranging from 5% to 10% on selling price of crude oil and natural gas. Sino-foreign cooperative joint ventures exploiting oil and gas resources onshore or offshore will be subject to resource tax in lieu of the existing mining royalty from the same effective date.

There are certain preferential treatments for taxpayers under the resource tax regime and the pilot schemes, such as crude oil used for heating or maintenance of an oil well during exploitation will be exempt from resource tax, reduced rate for extraction of heavy oil, and tertiary oil recovery.

Resource tax is also not levied on crude oil and natural gas produced by taxpayers that are used by them in a continued production process, and a deeming sales provision may apply if the self-use was for other purposes.

The resource tax reform was mainly for purposes of conserving resources and reducing negative environmental impact from mineral extractions, while some analysts believe this will also cause a larger portion of the profits from the resource companies to flow to the local governments.

Petroleum special profit tax

All enterprises (both domestic and foreign) that produce or extract crude oil from the territorial land or water of China and then sell this crude oil, whether within or outside of China, shall be subject to Petroleum Special Profit Tax. This tax was first launched in 2006 as part of a series of government measures to rationalize the pricing mechanism of petroleum and its products.

The Petroleum Special Profit Tax is levied when the monthly weighted-average price of crude oil sold exceeds $40 per barrel. And effective from November 1 2011, the Ministry of Finance has raised the exemption threshold of Petroleum Special Profits Tax from $40 per barrel to $55 per barrel.

This change in exemption threshold came about due to economic changes including rising oil cost. The reform of the resource tax regime, which is described above and also came into effect on November 1 2011, has facilitated this adjustment to potentially offset additional tax burden of oil enterprises.

Various progressive tax rates ranging from 20% to 40% that correspond with crude oil prices are specified. Essentially, the amount of levy per barrel is calculated as taking monthly weighted-average price per barrel sold, minus $55, multiplied by the applicable tax rate and minus a shortcut calculation deduction. The levy is calculated monthly and settled quarterly.

The progressive tax rates and deductions are as follows:

Crude oil price ($/barrel)	Tax rates	Shortcut calculation deduction ($/barrel)
55 – 60 (inclusive)	20%	0
60 – 65 (inclusive)	25%	0.25
65 – 70 (inclusive)	30%	0.75
70 – 75 (inclusive)	35%	1.5
Above 75	40%	2.5

Royalty for crude oil and natural gas

A petroleum royalty is generally calculated at progressive rates ranging from 2% for annual gross production (AGP) of over 0.5 million tonnes, to 12.5% for AGP over 4 million tonnes, on a block-by block-basis.

The royalty is paid in kind with the crude oil produced, and is based on the volume of annual production after deducting the volume of oil used in operation and depletion.

Sino-foreign onshore and offshore petroleum operations may be exempt from royalties, for example, companies whose annual production of crude oil is less than 500,000 tonnes located in provinces other than Qinghai, Tibet, and Xinjiang. A similar royalty mechanism is applicable on annual output of natural gas.

Withholding tax and tax treaties

Withholding tax rates on passive income such as dividends, interest and royalties are 10% in China.

China has over 90 tax treaties concluded with foreign countries and depending on the particular treaty countries, withholding tax rates may be reduced and can vary between 5% and 10% for dividends, between 7% and 10% for interest, and between 5% and 10% for royalties.

Investment into China

Inbound investments in the energy and resource sector would commonly take the form of either a joint venture (JV) or similar to a branch with permanent establishment (PE) in China due to certain restrictions on foreign investments in the sector.

Investment in oil and gas exploration and production (E&P) is commonly structured through a contractual joint venture (CJV) with a Chinese partner.

The Chinese partner is normally one of the three major national oil companies (NOCs) in China, who would own the E&P right of the oil fields. The foreign international oil companies (IOCs) would enter into a product sharing contract (PSC) with the Chinese NOC by contributing the operating fund, equipment, and modern science for its share of oil sharing.

In China, CJV can be either a legal entity or not. In most cases for the energy and resource sector, the CJV is structured as a non-legal entity, under which the NOC and IOC operate under the same name, but prepare financial statements and file tax returns separately.

In this regard, the IOC may need to have its own accounting and tax personnel in China in order to comply with the relevant regulations.

In cases where the CJV is structured as a non-legal entity, it is similar to a branch with permanent establishment as the IOC operates in China. There should generally be no tax implications when the CJV repatriates profit back to the IOC as China does not impose branch tax under the prevailing tax rules.

However, when the IOC transfers its interest in the PSC to another party, gain, if any, is taxable in China.

There were some controversies on the applicable tax arising from a transfer of economic interest in PSC. Some believed that this was comparable to a situation where a foreign entity transfers its permanent establishment in China and therefore is liable for capital gain tax taxed at 10%.

While others considered that under a PSC, the exploitation cost and development cost are deducted for Enterprise Income Tax purposes, so it is closer to business profits, which are taxed at 25%. It appears from case discussions with competent tax authorities that the latter is likely the case for which transfer of an interest in PSC is taxed.

There are also restrictions on foreign investments in respect of oilfield services. For example, a foreign company is not allowed to set up a wholly foreign-owned subsidiary in China engaging in drilling services.

Alternatively, it may have an equity joint venture (EJV) in China with a Chinese partner possessing the proper industry qualifications, or provide drilling services in China via PE on a project basis.

For an EJV, the upside is that the foreign company will be able to have a permanent presence in China through the form of a legal entity. The EJV will have its own brand name, local operations, local staff, and independent accounting and tax position.

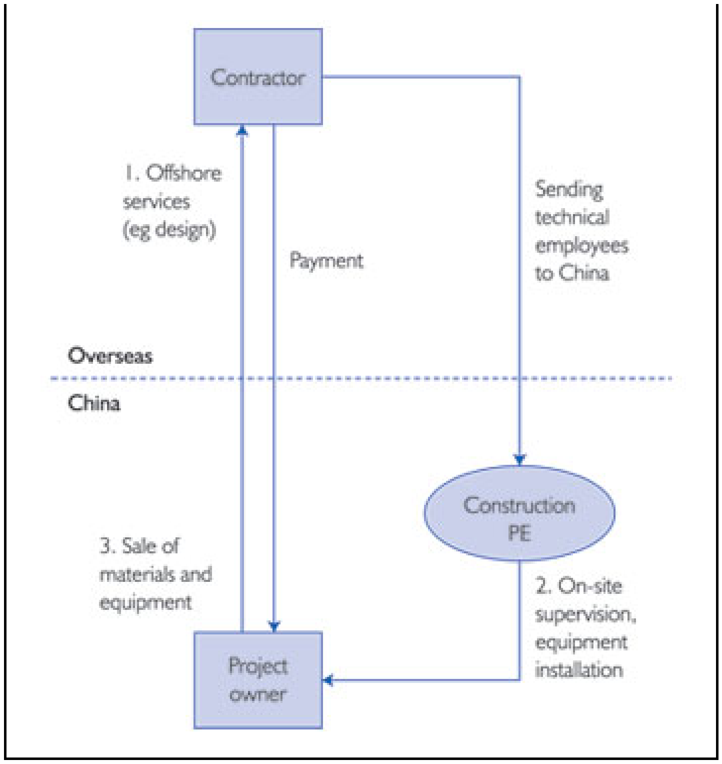
The downside is whether the foreign company can find a Chinese partner with proper qualifications that is willing to be bound together in the long term or whether the EJV will have sufficient contracts/projects to be profitable.

A foreign company that is a party to a CJV may send its staff into China to operate a project as a subcontractor of the project owner. According to recent tax administration regulations, construction PEs in China are required to perform registration with the competent tax bureau after the service contract is signed. The tax bureau will monitor the performance of the activities of the construction PE via the registration record until the service is completed and the fee is settled.

Diagram 1 illustrates a typical example of a foreign oil field service company providing services in China via a

DIAGRAM 1

PE. The major concerns related to the taxation of this



construction PE would include:

- What portion would be treated as China-sourced income and attributable to the PE and thus subject to China Enterprise Income Tax; and
- The deemed profit rate to be assessed by the competent tax authority (ranges from 15% to 30%).

Holding regimes may be used when structuring acquisitions or investing in China, often from a tax-efficiency-planning and business structuring perspective.

Common holding regimes include Luxembourg and Singapore. When structuring with offshore holding companies, the taxpayer should be aware that the Chinese tax authority has focused on beneficial owner status when applying treaty benefits.

This should be looked at on a case-by-case basis and the central government has issued a circular, listing some factors which are adverse to the determination of an applicant's status as a beneficial owner. In this regard, a pure conduit company lacking substance will likely not pass the beneficial owner test.

The Chinese tax authority also continues to target indirect transfer via intermediate companies registered in low-tax jurisdictions. Hence, use of an intermediary holding company for tax efficiency purposes that lacks substance may increase the risk of being audited or challenged by the Chinese tax authorities.

Transfer pricing

Transfer pricing in respect of related-party transactions should not be overlooked as China has issued and is aggressively implementing its comprehensive transfer pricing rules. The principal rule is that business transactions among related parties shall be priced at arm's-length standard.

If the tax bureaus consider that the related parties fail to follow this principle, reasonable adjustments may be made by the following methods: the comparable uncontrolled price, resale price method, cost plus method, transactional net margin method, profit split method, and other methods that are consistent with the arm's-length principle.

The concept of cost-sharing arrangements is present under the Enterprise Income Tax Law and taxpayers may apply for advance pricing agreements.

Trending upwards

Overall, Chinese outbound energy and resource investments will likely continue trending upward and expanding in scope and breadth. This evolving landscape along with China's fast economic growth leads to continuous changes in regulations and tax rules, and businesses, whether domestic or foreign, should stay informed of the trend, adapt and be flexible to achieve success in China.

Footnotes

1. Introduction is written in reference to these sources: (a) Oil and Gas Reality Check 2012. A look at the top 10 issues facing the oil sector. Deloitte Energy & Resources, (b) Borderless, Boundless. 2011 Greater China Outbound M&A Spotlight. Deloitte. Statistics on oil and gas reserves are pursuant to a news conference by the Ministry of Land and Resources dated February 23, 2012. Statistics on foreign investment in China's Extraction of Petroleum and Natural Gas Industry are according to surveys from Ministry of Commerce of the People's Republic of China.
2. Caishui [2010] No. 98
3. Caishui [2011] No. 7
4. State Council Decree No 605, No. 606 and No. 607
5. Caishui [2010] No. 54 (Circular 54), Regulations on Several Issues of Crude Oil and Natural Gas Resources Tax Reform in Xinjiang.
6. Caishui [2010] No. 112 (Circular 112), Regulations on Several Issues of Crude Oil and Natural Gas Resources Tax Reform in Region.
7. Articles from Reuters (Beijing) dated October 10, 2011, "China resource tax reform to go national from Nov. 1" and from China Briefing (Magazine and Daily News Service) dated October 13, 2011, "China Kicks off National Resource Tax Reform".
8. Circular Cai Qi [2011] No. 480 issued by the Ministry of Finance on December 29, 2011, effective from November 1, 2011.
9. But for a few exceptions, taxpayers with related-party transactions are required to prepare contemporaneous documentation, which is due either May 31 or June 20 depending on whether Guo Shui Fa [20009] No. 2 or Guo Shui Han [2009] No. 363 applies.

10. Reference to Borderless, Boundless. 2011 Greater China Outbound M&A Spotlight. Deloitte.

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Andrew is the national oil and gas tax service leader for Deloitte Great China. He has more than 20 years of experience in China, the US, and other international tax practices. Since joining Deloitte & Touche in June 1999, Andrew has worked in the Detroit, San Jose, Shenzhen, and Beijing offices.

He has been actively involved in a variety of outbound and inbound projects serving multinational clients such as Chevron, BP, and Hess, as well as many state-owned enterprises such as CNPC, CNOOC, and Sinochem.

Andrew has extensive experience on cross-border international mergers and acquisitions (M&A) tax matters, including tax structure optimisation, financing planning, disposition alternatives, PE fund structuring, initial public offerings-related tax services, and post-transaction integration services.

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Amy has almost 10 years of professional experience providing tax advisory and tax accounting services. She obtained in-depth experience practising business and international tax in Canada before working in China.

Her present and past clients include major publicly listed Canadian mining and resource companies, Chinese state owned resource enterprises, US multinationals in the consumer businesses, as well as other foreign-owned energy and resource and manufacturing companies operating in Canada and China.

With industry specialisation in the resource and consumer market sectors, Amy has experience in corporate reorganisation, international tax consulting including cross-border transactions, mergers and acquisitions, repatriation and exit strategy planning, and tax accounting / IFRS reporting.

Amy holds a masters degree in taxation from the University of Waterloo, Canada, and she is a certified general accountant in Canada.

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