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China Law Highlights

Independent Contractors

From a PRC tax perspective, there is no conclusive distinction of contractors from employees or clear definition of personal services performed by independent contractors. In practice, the tax authorities would consider the actual manner in which the individual performs services to determine if an employment relationship exists. All relevant factors may be examined in determining whether an individual is an employee or a contractor. Both the historical and current relationships between the parties could be considered to determine whether the services are employment services or personal services. No single factor may be determinative, but the existence of a work permit for foreign individuals would normally be a strong indicator that the individual is an employee.

In order to distinguish contractors from employees, it is necessary to understand the difference between a "contract for services" which involves a principal/contractor relationship and a "contract of services" where an employer/employee relationship exists.

The question is whether the individual engages himself/herself to perform the relevant services as a person in business on his/her own account. If this is the case, it is a contract for services where the individual performs services as a contractor in accordance with the contracting agreement and derives service fee from his/her principal demanding the services. Otherwise, it is a contract of services where the individual performs services and observes duties as an employee in compliance with the employment contract to his/her employer.

The extent of independence is also important in distinguishing contractors from employees. An employee receives employment income for the performance of dependent individual labor activities, whereas a contractor derives personal services income for the provision of independent labor services or various skills.

Characteristics of independent contractors

Independent contractors can usually be identified as possessing one or a number of the following characteristics:

Control	This refers to the degree of control exercised by the organisation demanding the services.
	The individual is not required to observe the restrictions on the working for other organisations.
	The individual is not required to comply with the rules and regulations of the organisation for which the work is performed.
	The individual is not required to attend a place of work at regular hours.
	The individual is not required to obtain approval for the leave from work.
Integration	This refers to the identity of the individual providing the services.
	The individual does not hold a position in the organisation for which the work is performed.
	The individual is not held out to the public as an officer of the organisation for which the work is performed.
Economic reality	This refers to the financial risk undertaken by the individual providing the services.
	The individual provides his/her or her own capital.
	The individual provides his/her or her own tools and equipment.
	The individual is not covered by workers insurance or entitled to staff medical or other fringe benefits provided by the organisation for which the work is performed.

The above characteristics are indicative of the extent of independence of an individual providing the services for an organisation demanding the services. Nevertheless, the tax authorities have broad discretion to evaluate all relevant conditions in relation to the extent of independence.

It is advisable to have a written agreement with the individual contractors. Prior discussion with the relevant tax authorities to confirm their opinion on this issue would be highly recommended.

Tax Case Analysis

Tax Evasion Case Involving by an Industrial Corporation Opening Two Bank Accounts

Reported by: Local Taxation Bureau, Shandong Province

Pre-Investigation Analysis

In May 2003, our office (Local Tax Bureau of Shandong Province) was transferred a case by the Tax Inspection Bureau of Shandong Province involving an industrial corporation hiding sales revenue and committing tax evasion by setting up two bank accounts and changing its company name every five years to avoid inspection by the tax authorities.

Based on the analysis and research of the report, we reviewed the tax registration status and tax returns of the taxpayer and found that the corporation had continuously changed its name and that sales revenue differed from the reported revenue. We initially believed that tax evasion had been committed, that the tax evasion was done in a covert way, and that the amount evaded was large. Therefore, our office decided to conduct a surprise tax audit of this corporation.

Basic Facts about the Corporation

This taxpayer is a limited liability company with a registered capital of RMB 5 million. The investors are Suo, Han and Liu. Han is the legal representative of the Corporation. The corporation received its business license and tax registration certificate in April 2001 and was confirmed by the tax bureau as a general taxpayer. It currently has 60 employees and primarily engages in the wholesale and retail business of mobile phones and accessories. Its previous name and company was, A Communication Equipment Co., was established in June 1997 and cancelled in May 2001.

The business model of the corporation is involves wholesale and retail and geographic reach covers all of Shandong Province. It's tax calculation is performed by financial software with part of the bookkeeping and tax calculation performed by hand, such as accounts receivable, purchase orders, etc.

Approaches and Methods Used in the Investigation

On June 9th, 2003, we conducted a surprise inspection of the corporation. We primarily reviewed relevant account books and tax payment documents the period of April 2001 to May 2003, as well as copied the internal computer files. After an initial review of the books and documents, we suspected this corporation of tax evasion. According to Article 55 of Management Act for Tax Collection of the PRC, we immediately took relevant tax preservation measures which included freezing the taxpayers bank account and seizing goods and inventory. We also took additional original documents containing management and finance information, and interviewed the general manager, financial officer, chief accountant, cashier, store keeper and oter staff members. Based on our work, we were able to confirm the correct taxable income and the VAT owed.

Illegal Acts of the Taxpayer

It was confirmed by investigation that this corporation committed tax evasion by opening two accounts and maintaining hidden account-books. The internal accounting records were composed of computer files and documents created by hand. The operating procedures were: during the sale of goods, the corporation divided these payments into two categories: payments with invoices (including value-added special tax invoice and plain invoice) and payments without invoices. For payments without invoices, the corporation deposited the cash payment into a personal account and the transaction was recorded in the internal management account book without including the transactions in the formal accounting records or on the filed tax returns. Only the external account books were used for tax declarations and inspections conducted by the tax bureau.

Check Results and Disposal Considerations

The amount of overdue tax and disposal considerations are made by the Municipal Tax Bureau after holding public hearing on administrative penalty required by the Corporation:

The Corporation shall pay the overdue value-added tax from April 2001 to May 2003, which is RMB 15,996,134.97 in total; RMB 15,968,885.15 of which is incurred from the hidden account, and RMB 27,249.82 is incurred from the wrong calculation of value-added tax. Investigation into the corporation's illegal acts and owed taxes has clearly proven these amounts. According to Article 32 of Management Act for Tax Collection of PRC, the unpaid tax shall be paid to the treasury within the established time limits and late fees shall be imposed.

The Corporation has hidden taxable sales revenue by establishing two bank accounts, not invoicing for parts of its purchases and sale, and depositing the cash payment into personal bank accounts. The amount of owed value-added tax is RMB 15,968,885.15 from May 2001 to May 2003.

Article 63 of Management Act for Tax Collection of PRC provides that "Evasion of tax" means that a taxpayer forges, revises, conceals or destroys without authorization the accounting books or supporting vouchers for the accounts, or overstates expenses or does not state or understates income in the accounting books, or refuses to file tax returns after having been notified by the tax authority to do so or files fraudulent tax returns, does not pay or underpays the taxes payable. For a taxpayer who evades taxation, the tax authority shall pursue payment for unpaid or underpaid tax, late fees, and impose a fine equal to 50% to 500% of the unpaid or underpaid tax.

The facts show that the corporation engaged in tax evasion. According to the Notice of State Administration of Taxation on the Issue of How to Determine the Amount of Tax Evasion and Payment of Penalty (Guo Shui Fa [1998]66 号), the amount of tax evaded was: RMB 10,438,534 for

2001, RMB 3,381,791for 2002, and RMB 2,148,559 from January to May,2003. The total unpaid tax was RMB 15,968,88. In view of the severity and serious nature of the tax evasion, a penalty payment of 100% of the underpaid tax is levied on the taxpayer equaling RMB 15,968,88 in line with the Management Act for Tax Collection of PRC.

Transfer this case to the Public Security Bureau for criminal investigation.

Through the investigation and analysis of this case, we found it had the following character:

(1) Continuous changing of the corporation's name to avoid tax inspection

The predecessor company of this Corporation is "A Communication Equipment Co., Ltd.", which was established in June 1997 and was cancelled on May 2001. This corporation was established simultaneously with "B Communication Co., Ltd." in April 2001, and "B" cancelled its tax registration on September 2002. Each of the above three companies have the same major investors, business scope, and place of business. According to what an informer told the tax bureau, this Industry Development Corporation will cancel its tax registration after June 2006 and a new corporation will replace it. From this information and our investigation, we determined that the taxpayers continuously changed the company name to avoid tax inspection and to commit tax evasion. The taxpayers established a new company while the old company continued to exist, and then later cancelled the old company after the new one commenced operations and took over the business of the former company.

(2) Open two accounts by using modernized office equipment

It was verified through investigation that the corporation evaded tax by opening two accounts and maintain two sets of accounting books. The corporation performed the above acts by way of modernized office equipment, such as computers, printers, scanners, and other office equipment. We found during the tax inspection that the accounting books reflecting the real purchases, sales, inventory, and money flow were maintained in a coded computer which was supervised by one specific person. These books and data were used to evaluate the performance of salesmen but was not used to declare tax.

(3) Hide the taxpayers true business performance through cash settlements and conducting sales of goods without invoices.

During its business operation, this corporation engaged in providing services without providing invoices to purchasers with payments for goods without invoices being deposited into personal bank accounts. This corporation also received goods, paying in cash, and not recording the receipt of inventory. The taxpayer engaged in many cash transactions, opening bank accounts in various banks, and depositing the funds in the name of individuals. Our office reviewed and seized 110 bankbooks and 3 bank cards which were in the names of individuals.

(4) The Sales Network Included all of Shandong Province

The taxpayer continued to use the sales network established by "A Communication Equipment Co., Ltd" from June 1997 to May 2001 which covered 17 cities throughout Shandong. It took full advantage of the relationship among these companies to evade tax by way of selling goods without issuing invoices and collecting cash payments. We found during the tax inspection that the corporation's illegal acts were committed through the cooperation of these network companies.

(5) Maintain the accounting books in violation of acceptable accounting practices and committing tax evasion in a planned way

It is confirmed from the tax inspection that the sales revenue the corporation used for its tax declaration was primarily from the sale of goods with invoices. This data was also used to calculate the supposed purchases of goods that would correspond to those sales, and the associated tax payments. We also found that this corporation indeed engaged in purchasing goods without claiming invoices.

Analysis of the criminal offenses

Through careful and deep analysis of this case, our conclusion is that the tax evasion occurred not only because of the taxpayers acts but because of the failure in taxation supervision, law enforcement, and taxpayer education.

(1) The taxpayer showed weak ethics in paying its tax. In today's social market economy, competition is fierce profits are decreasing while business costs are increasing. The manager involved in this case was driven by the benefit, had little respect for the law, used high-tech means to evade tax, damaged the national interest, pursued profit by wantonly evading tax payments, and caused a strong negative impact on social equity.

(2) The tax authorities supervision is not sufficient. One problem is a lack of relevant knowledge by the tax inspectors. The tax supervision departments do conduct periodic inspections and have insufficient awareness on preventing tax evasion. The second problem is that the internal tax supervision system is not perfect and the communication of information is not efficient which results in a poor tax monitoring system. The taxpayers place of business is very large and the amount of sales was abnormal compared to the size. However, the tax bureau did not act in a timely manner. The third problem is that earlier tax inspections involved only a review the taxpayer, which did not identify prior companies.

(3) The skills and abilities of some tax officers is not high enough. Tax offices have two functions: political and profession. An imperfect team will threaten the daily tax administration and collection and result in tax evasion.

(4) The tax authorities do not have enough power to enforce the tax laws. Taxpayers who wish to commit tax evasion will do so if the tax laws are lenient. It could be said that the tax authorities penalize the crime of tax evasion too lightly and that this is one cause of the failure of tax

management and supervision.

(5) The tax authority does not do enough to educate the public, which results in a weak understanding of tax law by the taxpayers. In recent years, tax education is conducted every year but not in an effective way. In some cases, taxpayers have a poor understanding of the tax law which causes the tax evasion to occur.

Tax News

The State Administration of Taxation Promulgates Announcement on the Rights and Obligations of Taxpayers

http://www.chinatax.gov.cn/n6669073/n6669118/9397471.html

Recently, the State Administration of Taxation (SAT) promulgated the Announcement on the Rights and Obligations of Taxpayers (hereinafter referred to as "the Announcement"). It is the first time the SAT systematically concludes and sorts out the provisions concerning the rights and obligations of taxpayers as prescribed by the Law of the People's Republic of China on the Administration of Tax Collection (hereinafter referred to as "the Law"), detailed rules for the implementation of the Law and relevant laws and administrative regulations for taxation in the form of normalized document, in which the rights and obligations of taxpayers are clarified.

It is prescribed by the Announcement that taxpayers are entitled to 14 rights in their fulfillment of tax liabilities, which include: rights to know, rights of confidentiality, rights of taxation supervision, rights of selecting appropriate procedures for tax declaration, rights of applying for deferred tax declaration, rights of applying for deferred tax payment, rights of applying for refund of overpaid tax, rights of enjoying tax concessions, rights of entrusting tax affairs to agents, representation and rights of defense, rights of rejecting tax inspection where inspector fails to present relevant certificate and notice, rights of applying for taxation remedies, rights of claiming hearing of witness, and rights of claiming relevant taxation receipts.

In compliance with the principle of equity of rights and obligations, the Announcement has also prescribed the obligations which taxpayers should earnestly perform in their fulfillment of tax liabilities. The obligations include: obligation of tax registration, obligation of establishing, safekeeping account books and relevant documents and issuing, employing, acquiring and safekeeping invoices, obligation of putting on record financial accounting rules and accounting software, obligation of installing and utilizing tax control devices in accordance with relevant rules, obligation of declaring tax liabilities timely and faithfully, obligation of paying taxes in a timely manner, obligation of withholding and collecting tax on an agent basis, obligation of accepting tax inspections, obligation of providing information in a timely manner, and obligations of reporting other tax-related information.

It is learned that the Announcement is promulgated for (i) facilitating taxpayers' apprehension of rights in their fulfillment of tax liabilities and enhancing taxpayers' awareness and capability of protecting their own interests, (ii) notifying taxpayers of relevant obligations for their fulfillment of tax liabilities and facilitate taxpayers' completion of taxpaying procedures, so as to promote the constant increase in taxpaying compliance, and (iii) standardizing tax administration, administrative enforcement of law and provision of tax services of tax authorities and personnel, further promoting tax administration in accordance with law, and striving for harmonious relationships between tax authorities and taxpayers.

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