Three Scenarios that Lead to an Audit in China

TAGS Taxation Business Basics

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Receiving a visit from the tax authorities is never a pleasant surprise. To lower the risk of an audit in China, here are three scenarios to know.

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This is the fourth of a set of articles on legal and tax-related aspects for operating a business in China, mainly through a legal entity in the country. Read here the first article on registered capital in China, the second article on setting favourable tax terms in your sales contracts, and the third on tax planning. This article was written by Integra Group, an established provider of company secretarial, accounting, tax, HR, and financial advisory services in China.

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Receiving a visit from the Tax Authorities is never a pleasant surprise. Even well-intentioned and honest businesses in China can get penalised for unqualified fapiaos, missing supporting documents, and simple mistakes made by employees. The best way to avoid these tax risks is to maintain a complete and accurate set of books. The reality in China is that most businesses are exposed to many hidden tax risks caused by negligence or simply by poor quality accounting.

These risks are very likely to come to the fore during tax audits. A poorly kept set of books not only creates additional tax liabilities for the business if audited. It also makes responding to tax officers' request for additional documentation time consuming for the business. Companies can also see their credit level decrease from A to B, C or D, with devastating consequences and limitations on future business operations.

To avoid these repercussions, following PRC GAAP and tax regulations is fundamental. Knowing what can trigger a tax auditing, business owners can take the necessary precautions to minimise the likelihood of receiving unwanted attention from the tax authorities.

Scenario 1 – Getting reported to the tax authorities

In China, a good relationship can get you a meeting with the right people; a bad relationship can be damaging to your business. One example of this is being reported to the tax authorities with or without substantiated cause.

Avoiding such a scenario is the best option. Unhappy business partners, disgruntled employees, minority shareholders, and even clients make up your most likely reporters. Even when there is no substantial wrongdoing, a tip from one of these individuals can trigger unwelcome attention from the tax authorities.

It is important for managers and business owners to be careful in ensuring that all of their business dealings with their employees, clients and partners are clearly laid out in the terms of their contracts. Any contract termination should remain not only in full compliance with the contractual terms and applicable laws, but also with appropriate concessions to avoid creating potential liabilities for your business.

Such tax risks cannot be managed entirely by finance personnel. Reducing this risk often requires making changes to the company culture. This means educating your staff on how to handle unsuccessful client relationships, how to terminate contracts. It also means implementing the right human resource policies.

Scenario 2 – Red flags in your financial reports

With China's "Golden Tax IV" big data, Chinese tax authorities are able to systematically and efficiently spot any potential fraudulent behaviour through the VAT invoicing system and financial reports submitted by a company. Tax reports, financial reports, fapiao information, social security filing, customs clearance, business registration and many other documents are integrated into a unified system. For instance, if the system recognises a mismatch of gross salary between an individual income tax (IIT) declaration report and the corporate income tax (CIT) declaration report, this creates an alert that can prompt the tax authorities to investigate.

Repeated and/or consistent abnormalities in financial figures will attract increasing attention from the tax authorities. With every subsequent alert, your business becomes more likely to have to produce supporting documents or risk an audit.

Most of the common fraudulent activities that businesses in China engage in to minimise their tax liability are easily spotted through big data.

Scenario 3 – Legal entity deregistration

Deregistering a company in China requires a full-scope tax audit to ensure the business does not have any outstanding tax liabilities. This is the last chance for the tax authorities to collect tax revenue from the business, so expect them to be thorough. Before closing a company, you must be sure that you will pass the corporate income tax clearance and avoid a hefty tax payment upon deregistration.

Many businesses take advantage of the lower tax rate associated with being a small-scale taxpayer by opening several legal entities. They often fail to maintain an accurate set of books. The financial reports often contain significant tax risks that result from poor-quality bookkeeping.

Learn how to assess your tax risk by looking at your balance sheet. When deregistering, a tax audit is unavoidable. Make sure to eliminate any tax liabilities before considering this step to avoid fines and penalties.

How to protect your business against a tax audit

Avoiding a tax audit altogether is simply the best way to minimise the costs associated with compliance. Maintaining a complete and accurate set of books is the best way to minimise the negative consequences associated with being audited. Complete and accurate bookkeeping also help minimise the chances of being audited on the past five years or more, instead of on the past year only.

Your financial department should be aware of those possible scenarios and guide you towards safe financial choices. If your financial manager is not skilled enough on this matter, you may consider seeking the support of external professionals.

For most businesses, a virtual CFO is a cost-effective way to structure the financial function of your business. Virtual CFOs are senior financial professionals using cloud accounting technologies to achieve the necessary visibility of sales, purchasing, business expenses and other functions to work inside your business, as opposed to as an outsider. This allows them to efficiently perform the role of a traditional CFO at a fraction of the price.

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