



CHINA BRIEFING

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Tax Health and Dispute Strategies for Foreign Firms in China

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Introduction



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For foreign-invested enterprises (FIEs) operating in China, tax health is no longer just a compliance matter — it has become a critical element of competitiveness. In today's regulatory environment, businesses that proactively manage their tax affairs are better positioned to reduce risk exposure, access preferential policies, and maintain a constructive relationship with tax authorities.

Amid ongoing fiscal pressure, China's tax authorities are sharpening their enforcement tools and tightening compliance oversight. The adoption of advanced technologies, such as big data analytics and the fully digitalized Golden Tax Phase IV system, has enabled precise, real-time monitoring of tax behavior. At the same time, authorities are pushing forward with credit-based tax administration, rewarding compliant taxpayers with significant administrative and financial incentives, while increasing scrutiny of high-risk entities.

This environment places foreign companies under heightened pressure to ensure accurate filings, identify and address red flags early, and document transactions thoroughly. Meanwhile, improperly handled audits or disputes can escalate quickly — resulting in costly penalties, operational disruptions, and reputational damage.

This issue of China Briefing magazine explores how foreign businesses can proactively establish and maintain tax health, navigate audits effectively, and resolve disputes strategically. Drawing on recent policy developments, practical case examples, and expert guidance, we provide a roadmap for managing tax risks in China with foresight and confidence.

In a landscape where tax enforcement is increasingly sophisticated, staying compliant is no longer enough — being proactive is essential.

With kind regards,

Sabrina Zhang



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Why Tax Health Is a Strategic Priority in China

With rising fiscal pressure and expanding digital oversight, China is tightening tax enforcement. This chapter explains why maintaining strong tax health is now a strategic priority for foreign firms—impacting audit exposure, access to incentives, and long-term credibility in an increasingly data-driven compliance environment.



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As China's business environment becomes more regulated and data-driven, the concept of "tax health" is rising to strategic importance—especially for foreign-invested enterprises (FIEs). Maintaining good tax health means more than avoiding penalties or passing audits. It reflects a company's ability to operate with transparency, access government support, and reduce financial and reputational risk.

In recent years, several developments have converged to raise the stakes for tax compliance in China: intensifying fiscal pressure, enhanced enforcement capabilities, the nationwide expansion of tax digitalization, and the rise of taxpayer credit systems. These changes are reshaping how foreign businesses must view and manage their tax obligations.

This chapter explores the macroeconomic and regulatory dynamics behind China's increasingly refined tax environment and explains why building and maintaining strong tax health is becoming essential to long-term business success in the country.

Fiscal pressure is reshaping tax enforcement priorities

China's public finance system is under increasing strain. From January to May 2025, the country's general public budget revenue stood at RMB 9.66 trillion (US\$1.33 trillion), showing a modest year-on-year decline. Within this, tax revenue accounted for RMB 7.92 trillion (US\$1.09 trillion), falling 1.6 percent compared to the same period in 2024. Several major categories contributed to the downturn:

- **Corporate income tax (CIT):** Decreased by 2.5 percent. In the first two months alone, CIT revenues fell 10.4 percent, largely due to reduced profit contributions from central financial enterprises—a sign of broader corporate profit pressure.
- **Customs duties:** Down 9.2 percent, reflecting lower import activity and global trade tensions.
- **Land appreciation tax:** Down 16.8 percent, as adjustments in the real estate sector continue to weigh on local tax bases.

On the other hand, budget expenditures increased by 4.2 percent to over RMB 11.3 trillion (US\$1.56 trillion), driven by inflexible spending obligations in areas such as healthcare, education, and social welfare. At the same time, expectations for additional fiscal stimulus to support economic growth are placing further strain on public finances.

In this context, tax authorities are under strong pressure to preserve fiscal stability—by closing compliance loopholes and tightening administration. While the policy direction does not suggest heavier tax burdens, it does signal reduced tolerance for inefficiencies, errors, or aggressive tax practices.

Key implication for FIEs: Refinement of tax enforcement is now a policy imperative. Tax health protects businesses from being caught in the crosshairs of tightened fiscal oversight.

Digitalization is transforming how tax compliance is monitored

China's tax enforcement model is evolving rapidly with the support of new technologies. At the heart of this transformation is the Golden Tax Phase IV system—a national initiative integrating real-time data analytics, AI-based risk scoring, and cross-departmental data exchange. Several tools and mechanisms now power this data-driven enforcement approach:

- **Smart e-invoicing (e-fapiao):** All enterprises are transitioning to digital invoices, creating a fully traceable tax trail.
- **Automated risk identification:** Algorithms can flag discrepancies across corporate filings, financial reports, and payroll data.
- **"Taxation by data":** Authorities are shifting

from reactive checks to proactive detection of anomalies—sometimes in real time.

As these technologies mature, tax authorities are now better equipped to detect irregularities in areas such as:

- Value-added tax (VAT) chain mismatches;
- Fraudulent VAT invoices;
- Improper expense classification and deduction;
- Excessively low employee tax or social security contributions; and
- Unreasonable transfer pricing arrangements.

In this high-transparency environment, even small compliance gaps can trigger scrutiny. For FIEs, building systems to mirror the sophistication of enforcement tools is essential.

Taxpayer credit ratings now influence business outcomes

Alongside digital transformation, China is also institutionalizing credit-based tax governance. Through the State Taxation Administration's unified rating system, companies are assigned a credit grade—A, B, M, C, or D—based on their past tax performance and filing behavior.

A-grade taxpayers enjoy benefits such as:

- Streamlined VAT refunds and higher invoice quotas;
- Lower audit frequency; and
- Priority access to pilot incentives, government-supported projects, and enhanced financing opportunities, including bank loans and other credit facilities.

For example, Qinghai province recently announced 44 facilitation measures for A-grade taxpayers across taxation, project financing, and regulatory approval channels. These include reduced audit

How China's Digital Tax System Identifies Non-Compliance

1

Real-time data collection

Invoices, payroll, bank transactions, customs records, and financial reports are uploaded automatically via Golden Tax Phase IV.

2

Data integration

Cross-departmental databases (tax, customs, social security, market regulation) consolidate taxpayer information.

3

Algorithmic risk detection

AI analyzes inconsistencies in tax declarations, unusual patterns, and cross-year comparisons.

4

Automated red flags

Triggers include: mismatched VAT chains, frequent invoice revisions, excessive deductions, and related-party anomalies.

5

Taxpayer profiling

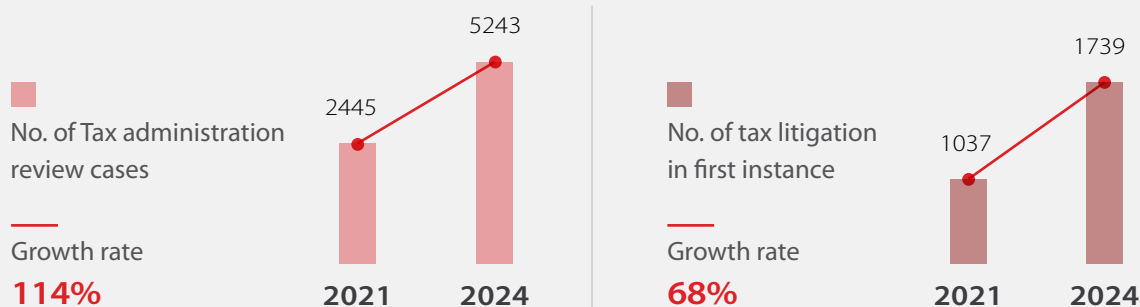
Tax credit rating is updated based on compliance behavior, risk level, and cooperation history.

6

Audit decision or compliance incentive

High-risk taxpayers are flagged for audit; low-risk taxpayers enjoy faster refunds, fewer inspections, and policy facilitation.

Number of Tax Disputes in China (2021-2024)



sampling, priority in fund allocation, and eligibility for preferential policies.

D-grade taxpayers, by contrast, face stricter scrutiny, limited access to public resources, and reputational risks when dealing with government departments. This system reflects a broader shift toward incentive-driven compliance, in which trustworthiness unlocks efficiency and opportunity. As credit ratings become an operational currency in China, businesses must view tax compliance not only through the lens of risk prevention, but also as a way to enhance their market position.

Increasing volume and complexity of tax audits and disputes

Along with enforcement upgrades, China is seeing a steady rise in tax inspections, reviews, and legal disputes—especially in technically complex areas.

Several factors contribute to this trend:

- The rollout of digital systems makes audits easier to initiate and harder to contest;
- Ongoing implementation of BEPS-related measures, such as country-by-country reporting (CbCR) and the Common Reporting Standard (CRS), has made cross-border activity more transparent; and
- Increasing reliance on interpretation of detailed tax rules—such as expense deductibility, high-tech enterprise qualification, and transfer pricing—has created more opportunities for disputes between taxpayers and authorities.

Foreign companies, particularly those with complex structures or international operations, are at higher risk of audit escalation. While many disputes are still resolved during the review stage, a growing number proceed to administrative reconsideration or even litigation.

Tax disputes are no longer isolated events. They are becoming part of the normal operating environment for foreign firms—making prevention, preparedness, and negotiation skills critical.

Key takeaways

Tax health has become a strategic imperative for foreign firms in China. The convergence of fiscal pressure, regulatory refinement, and digital enforcement has dramatically changed the landscape in which FIEs operate.

Firms that treat tax health as a core part of their business strategy—investing in systems, building internal awareness, and staying ahead of regulatory trends—will be in a far stronger position to manage risks, unlock opportunities, and build lasting relationships with tax authorities.

As subsequent chapters in this publication will show, maintaining tax health requires more than filing on time. It demands regular internal reviews, strategic use of incentives, effective audit handling, and—when necessary—skilled dispute resolution. In China's evolving tax environment, these are no longer optional practices, but essential components of a resilient and competitive business. 



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Building and Maintaining Tax Health

Building and maintaining tax health in China requires robust planning, accurate implementation, and regular reviews. This chapter outlines practical, high-impact strategies that foreign companies can adopt to build a strong, efficient, and low-risk tax position in China.



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As discussed in Chapter 1, the concept of “tax health” has become increasingly important for foreign-invested enterprises (FIEs) operating in China’s evolving tax landscape. To safeguard operations and minimize tax exposure, companies must move beyond basic compliance and adopt a proactive, structured approach to tax management. This chapter provides practical guidance on how to build a strong, low-risk tax position in China.

Defining tax health

Again, in today’s China, tax health goes beyond simple compliance. Instead, it reflects the overall strength, stability, and defensibility of a company’s tax position in the eyes of regulators. From our experience working with FIEs, a company’s tax health is best evaluated through three interrelated pillars:

- **Efficiency:** A tax-healthy company makes strategic use of available tax incentives, exemptions, and deferrals to lawfully reduce its tax burden and improve liquidity. Equally important, however, is

ensuring that tax rules are correctly interpreted and applied. Misunderstanding policies or adopting overly conservative positions can result in unnecessary overpayment of taxes—an avoidable cost in a competitive market.

- **Risk control:** This involves proactively identifying potential exposures, managing uncertain or sensitive tax positions through advance rulings, and implementing robust internal controls to prevent errors and inconsistencies.
- **Credibility:** Under China’s credit-based tax administration model, credibility matters. Companies that demonstrate a history of timely and accurate filings, full disclosure, and constructive engagement with tax authorities are more likely to benefit from streamlined procedures and preferential treatment. Strong credibility translates into fewer inspections, quicker refund processing, and eligibility for “green channel” policy privileges.

To put it simply, a truly “tax healthy” company should excel across all three dimensions. It maintains

strong internal systems to manage risk, actively pursues lawful savings opportunities, and cultivates regulatory goodwill, positioning itself as a trusted taxpayer in the local jurisdiction.

Strategies for building and maintaining tax health in China

As emphasized in the previous section, tax health is not achieved through a single compliance task—it requires continuous attention, strategic planning, and cross-functional coordination. This section outlines a set of focused, high-impact actions that foreign companies can take to strengthen their tax position across the three core dimensions of tax health. While not exhaustive, the strategies below reflect best practices observed among well-managed FIEs in China.

Strengthen internal tax governance

Effective tax governance starts with structure and accountability. FIEs should establish clearly defined roles and responsibilities for tax matters across departments, supported by documented procedures for tax-sensitive decisions such as pricing, cost allocations, incentive applications, and restructurings. A sound governance framework ensures that tax is embedded into operational planning—not handled reactively. At a minimum, this includes:

- Appointing a tax lead or internal owner for oversight and coordination;
- Establishing review and escalation mechanisms for tax-related risks; and
- Ensuring regular cross-department communication between operation, finance, HR, and legal.

By institutionalizing tax risk management, companies are better positioned to identify exposures early,

respond to regulatory changes, and avoid inconsistent or isolated decision-making.

For smaller FIEs or those newly entering the China market—who may not yet have a full-fledged finance or tax team in place—engaging a third-party virtual CFO service can be a practical and cost-effective solution. This arrangement allows companies to assign a dedicated tax professional to serve as their interim tax head, filling critical governance and compliance gaps. This will not only ensure tax obligations are properly managed but also helps the business build a scalable structure that aligns with China's regulatory expectations from the outset.

Leverage digital tools to enhance compliance and control

As China's tax administration becomes increasingly digitalized, it's also important for FIEs to leverage technologies to strengthen compliance, improve control, and drive efficiency. Manual processes or siloed systems increase the risk of discrepancies, late filings, and overlooked risks. Leveraging digital tools in tax management usually involves deploying relevant systems (such as ERP) or integrating relevant technologies (such as AI capabilities) to enhance their internal tax and accounting management, which are usually capable of supporting real-time reporting and auditability. Key areas to focus on include:

- Integrating ERP systems with Golden Tax System interfaces;
- Automating VAT-related processes, such as fapiao issuance, collection, and validation;
- Using anomaly detection tools to flag inconsistencies in employee expenses, intercompany transactions, or declaration patterns; and

- Analyzing financial and tax index and identifying potential tax risks.

By building a strong digital foundation, companies can minimize human error, streamline tax operations, and stay ahead of audit risks in China's data-driven compliance landscape. To be noted, while a unified, company-wide digital system offers comprehensive automation, modular and progressive automation and digitalization are practical solutions for small and medium sized enterprises facing cost constraints.

ERP-as-a-service – A ready-built, one-stop ERP solution

In contrast to more complex ERP localization efforts—such as customizing a global ERP system for China—ERP-as-a-service provides a ready-built, cloud-hosted ERP platform delivered by a service provider. This model allows businesses to access ERP functionalities over the Internet and pay through a monthly or annual subscription, commonly referred to as Software-as-a-Service (SaaS) ERP.

ERP-as-a-service providers handle configuration, maintenance, upgrades, data security, and hosting, allowing businesses to focus on operations while benefiting from:

- Rapid deployment;
- Lower upfront costs;
- Centralized access and advanced performance; and
- Improved data security and business continuity.

This solution is particularly well-suited to smaller enterprises seeking the advantages of integrated business processes without the complexity and cost of full-scale ERP implementation. However, it should be noted that ERP-as-a-service may offer limited customization. Companies requiring highly tailored functionality may need to weigh this limitation against the cost and speed advantages.

Maximize preferential tax policies—with discipline

China offers a broad array of tax incentives for eligible enterprises to incentivize or encourage a particular industry, including tax exemptions, reductions, lower rates, refunds, credits, and deferrals. While these incentives can significantly improve a company's tax efficiency, improper application or insufficient documentation may result in claw backs, penalties, or reputational risks. FIEs must therefore approach incentive planning with precision and discipline.

For most preferential tax policies, taxpayers may self-assess their eligibility and directly apply the benefit at the time of pre-payment or final settlement—without needing prior approval from the tax bureau.

However, a correct and up-to-date understanding of eligibility criteria is essential.

For FIEs, maintaining tax health means ensuring that:

- All eligible incentives are fully and accurately claimed;
- Incentives are not misapplied due to misunderstanding of qualifying conditions; and
- Supporting documentation is properly retained in anticipation of future tax bureau reviews.

To successfully benefit, companies should conduct a feasibility analysis, maintain comprehensive supporting documents (including payroll, contracts, and R&D records), and align claims with financial statements. Importantly, companies must avoid common mistakes such as:

- Relying on outdated qualification criteria;
- Inconsistencies between financial and tax declarations; and



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- Failing to report in accordance with the required timeline.

Precision, not aggressiveness, is the hallmark of sustainable tax efficiency.

Conduct regular tax health self-assessments

Internal tax health reviews are another effective tool for identifying hidden exposures, preventing costly errors, and improving readiness for tax audits. While the strategies introduced earlier are all essential components of a sound tax management strategy, regular tax health checkups serve a distinct and indispensable function: they bring all the moving parts together into a structured, forward-looking review process.

To be more specific, a tax health check provides a comprehensive, internal checkpoint that evaluates whether all tax systems, decisions, and practices are actually working together as intended. It helps companies:

- **Detect unintended gaps or mismatches**, for example, between ERP-generated data and manual tax filings, or between incentive claims and the underlying financial records;
- **Test the effectiveness of controls and compliance routines** that may otherwise be assumed to be functioning correctly;
- **Reassess risk areas that evolve over time**, such

as new intercompany transactions or changes in business models, which may introduce exposure not covered by existing systems or routines;

- **Identify inconsistencies that only surface across functions**, such as HR, procurement, and finance—something digital tools or isolated workflows may not flag; and
- **Proactively correct issues before they escalate**, instead of discovering them reactively through audits, system failures, or missed deadlines.

In short, tax health reviews are not just another control—they are the coordinating mechanism that ensures all tax-related activities remain aligned, accurate, and adaptable. Without this regular self-check, even the most well-designed systems and incentives can become blind spots over time.

What to include in a tax health review

A well-designed tax health assessment should cover all high-risk and high-value areas of a company's tax operations. For FIEs, typical focal points include:

- **Tax filing and reporting processes:** Evaluating whether deadlines are met, systems are properly integrated, and roles and responsibilities are clearly defined across departments;
- **VAT compliance:** Reviewing the consistency and accuracy of VAT fapiao issuance, input verification, and offset calculations to ensure alignment between transaction records and tax declarations;
- **Transfer pricing:** Assessing whether intra-group transactions follow the arm's-length principle and are supported by up-to-date benchmarking analysis, especially in light of China's heightened scrutiny of intangible assets and service charges;
- **Cross-border payments:** Verifying the correct application of withholding tax on outbound payments, such as service fees, interest,

royalties, and dividends, and ensuring proper documentation (for example, contracts, tax residency certificates) is in place; and

- **Incentive eligibility:** Confirming qualification for and compliance with preferential policies, such as R&D super deductions or profit reinvestment tax deferral and credits, with supporting materials properly retained for future audits.

Who should conduct the assessment—and how often

Ideally, tax health reviews should be conducted **annually before the year-end closing**. For more complex operations or during periods of significant business change—such as restructuring, expansion, or changes in personnel—mid-year or ad hoc reviews may also be warranted.

The assessments can be led by an internal finance or tax function, if sufficiently resourced, but external advisors are often engaged to bring in fresh perspectives, benchmark practices against industry standards, and ensure alignment with the latest tax enforcement trends. Small or newly established FIEs without an in-house tax team may consider appointing a third-party advisor or leveraging virtual CFO or tax director services to conduct the review.

Turning assessment into action

Tax health checks should not be treated as a box-ticking exercise. Findings should be documented and prioritized based on severity and impact, with clear follow-up actions and timelines for remediation. Moreover, patterns observed in recurring issues may point to broader gaps in internal processes, system integration, or training, and present an opportunity to strengthen overall governance and efficiency. By conducting regular tax health assessments, companies gain the confidence of knowing they are operating within regulatory boundaries while also

identifying opportunities to optimize tax positions, reduce unnecessary costs, and maintain credibility with tax authorities.

Proactively build credibility with local tax authorities

In China's credit-based tax management regime, a company's track record directly affects how it is treated by tax bureaus. High-credit taxpayers are more likely to enjoy administrative convenience, policy access, and reduced audit scrutiny. Key practices for strengthening tax credibility include:

- Ensuring timely, complete, and accurate filings across all tax types;
- Maintaining transparent and well-organized documentation that can withstand inspection;
- Demonstrating a constructive attitude during audits or inquiries; and
- Proactively engaging with tax authorities when making material changes (such as restructuring, large-scale incentives, or changes in business model).

Long-term relationships with local tax officials—built on trust and professionalism—can offer valuable support in interpreting policies or resolving ambiguities in grey areas. More details will be presented in the following chapters.

Case spotlight

A European manufacturer operating in eastern China conducted a routine internal tax health check shortly after expanding its operations to a second city. Though the company maintained generally sound compliance, the internal review, led by its finance team in coordination with an external tax advisor, revealed discrepancies between the issuance of VAT fapiao and revenue recognition timelines in its ERP system.

The issue stemmed from inconsistent practices between its two branches: one location issued fapiao based on shipment dates, while the other relied on invoicing dates. This mismatch led to inaccurate monthly VAT filings that had gone unnoticed for several quarters. Though the financial impact was not immediately significant, the risk of audit-triggered penalties and late payment surcharges was real.

By identifying the issue early through the health check, the company was able to:

- Reconcile discrepancies and file corrected declarations with the local tax bureau;

- Avoid penalties by proactively disclosing the issue before any formal audit was initiated; and
- Standardize internal procedures and ERP configurations to ensure consistent VAT treatment across locations.

This case highlights the value of proactive tax risk detection. A self-initiated health check not only uncovered a hidden compliance vulnerability but also provided the company with a learning opportunity to strengthen internal controls. It also built credibility with local tax authorities by demonstrating a responsible and transparent tax governance position. 

Practical Measures to Build and Maintain Tax Health in China	
Dimension	Key measures
Risk control	• Conduct regular, structured tax health checks covering key risk areas—such as transfer pricing, VAT invoicing, R&D claims, and outbound payments—to identify potential exposures early; • Seek advance rulings or clarifications from tax authorities when dealing with ambiguous or high-value transactions; • Establish automated checks within financial systems to flag inconsistencies or anomalies in real time (e.g., mismatches between fapiao issuance and accounting records); and • Strengthen internal controls through SOPs and periodic reviews, especially around intercompany charges and employee benefits reporting.
Efficiency	• Review eligibility for national and local tax incentives regularly (e.g., high-tech enterprise status, super deductions, regional subsidies), and maintain documentation to support qualification; • Analyze cross-border business flows to utilize tax deferral or exemption mechanisms, such as those available for reinvested profits or treaty benefits; • Coordinate with business and finance teams to ensure tax policies are interpreted correctly—avoiding common pitfalls like missing out on VAT exemptions or overpaying due to outdated assumptions; and • Reassess organizational structures periodically to ensure alignment with evolving tax-efficient practices (e.g., IP location, cost-sharing arrangements).
Credibility	• Maintain a spotless filing and payment history through disciplined internal timelines and multiple layers of review before submission; • Engage proactively with local tax officers through regular communication, status updates, and prompt, transparent responses to inquiries; • Monitor the company’s tax credit rating, address any deductions in real time, and aim to achieve Class A status, which grants access to simplified compliance procedures and reduced scrutiny; and • Participate in government pilot programs or voluntary disclosure initiatives to demonstrate commitment to good-faith tax governance.



Handling Tax Audits and Investigations

Tax audits aren't just about numbers—they're shaped by strategy and tone. This chapter explores how thoughtful preparation and constructive handling of audits can protect both compliance and reputation.



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Tax audits or investigations refer to the formal review and enforcement actions conducted by tax authorities to assess the tax compliance of taxpayers or withholding agents.

Even for companies that have made substantial effort to ensure strong tax health, tax audits may still occur, such as those based on random checks.

Receiving a tax audit notice does not necessarily mean there is a problem, but how a company responds can be critical. In some cases, the response may significantly influence the outcome.

This chapter provides guidance on how to proactively prepare for tax audits, respond with professionalism and clarity, and minimize the risk of escalation.

When handled properly, a tax audit can not only avoid penalties but also serve as an opportunity to reinforce the company's credibility and build trust with tax authorities.

Triggers, process, and timeline of a tax audit

A tax audit in China can be triggered by a variety of factors and understanding these helps businesses stay alert and prepared. In general, audits fall into two categories: risk-based audits and random checks. Common audit triggers include:

- **Risk profiling:** China's tax authorities employ data analytics and risk profiling to identify anomalies in tax declarations. Discrepancies between VAT invoices and tax filings, aggressive incentive claims, or inconsistent intercompany transactions are often flagged.
- **Industry-specific scrutiny:** Some sectors are subject to more intensive monitoring due to historical noncompliance or policy focus. For example, real estate, pharmaceuticals, and high-tech industries often receive closer scrutiny.
- **Whistleblowing or third-party reporting:** Reports from former employees, competitors, or business partners may lead to targeted investigations.

- **Tax refund applications:** Applications for export VAT refunds or excess input VAT credits often prompt audits.

Tax audits in China typically follow a formal process:

- 1 Notification:** Companies may receive a notice of inspection or an inquiry letter outlining the scope of the audit.
- 2 Field visits:** Depending on the case, tax officials may conduct on-site reviews and interviews, usually lasting one to several weeks.
- 3 Information request and submission:** Taxpayers are asked to provide documentation, such as financial statements, contracts, invoices, and internal policies, within specific deadlines.
- 4 Review and feedback:** After reviewing the materials, the tax bureau may issue additional questions or a preliminary assessment.
- 5 Conclusion and penalties:** If issues are found, a notice of adjustment and potential penalties are issued. Companies have the right to respond or appeal.

From initiation to closure, an audit may last from several weeks to a few months, depending on its complexity and the company's responsiveness.

How to respond to a tax audit effectively

When facing a tax audit, how a company responds is just as important as what it submits. In most cases, the outcome of an audit does not solely depend on the underlying tax positions—but also on the company's attitude, level of preparedness, and ability to communicate clearly with authorities.

As mentioned, a tax audit is not necessarily a sign that something is wrong. Authorities may conduct inspections based on industry focus, data analytics, or random selection. Yet once a company is under review, every interaction and piece of information provided becomes part of the tax bureau's assessment. A cooperative, transparent approach can de-escalate tension and foster goodwill, while defensive or disorganized responses can lead to deeper scrutiny, prolonged inquiries, or harsher penalties.

In many real-world cases, companies with similar technical exposures have faced very different results. Some receive minor adjustments or even clean conclusions, while others have ended up with sizable penalties or follow-up investigations. The difference often lies in how early the company took control of the process, how clearly it explained discrepancies, and how well it coordinated internally.

That is why an effective audit response is not a passive exercise in compliance. It is a demonstration of the company's tax governance, communication readiness, and respect for regulatory procedures. The following steps offer a structured approach to managing audits with confidence and minimizing risks:

- 1 Assemble a cross-functional response team:** Tax audits are often time-sensitive and resource-intensive. A fragmented or reactive approach can lead to inconsistent information being submitted and missed deadlines—both of which may signal weak internal controls to auditors. Moreover, audits typically require input beyond the tax function. Establishing a small, well-coordinated team that includes representatives from operation, finance, legal, tax, and external advisors (if necessary) helps ensure clear communication, avoid duplication of efforts, and maintain control throughout the audit process.

2 Prepare and reconcile key documentation upfront: Before any documents are requested, ensure core tax filings, statutory accounts, invoices, contracts, and incentive qualification files are in order. Reconcile book-to-tax differences and confirm that transfer pricing documentation is current and defensible. Preparing thoroughly helps companies stay one step ahead and limits room for misinterpretation.

3 Explain discrepancies proactively and clearly: Do not wait for tax authorities to raise questions. When discrepancies arise—such as income recognized for accounting purposes but not yet subject to tax—address them upfront. Walk the auditors through the rationale and back it up with clear documentation, including reconciliations, supporting schedules, and relevant internal policies. Delayed or vague responses can raise red flags and erode trust. By addressing issues early and transparently, a company can not only demonstrate good faith but also place it in a stronger position to resolve potential disagreements.

4 Monitor and manage deadlines rigorously: Respecting the audit process builds rapport. Companies are advised to treat submission timelines as fixed commitments. If delays are unavoidable, formal extension request with reasonable justifications and a clear plan for follow-up are highly recommended. Informal or last-minute deferrals may create unnecessary negative impressions.

5 Prepare for interviews like they're high-stakes meetings: During audits, tax officers may request interviews with finance team members or management. Companies should ensure everyone is aligned on key facts, aware of sensitive positions, and trained to respond with clarity and professionalism. Well-briefed

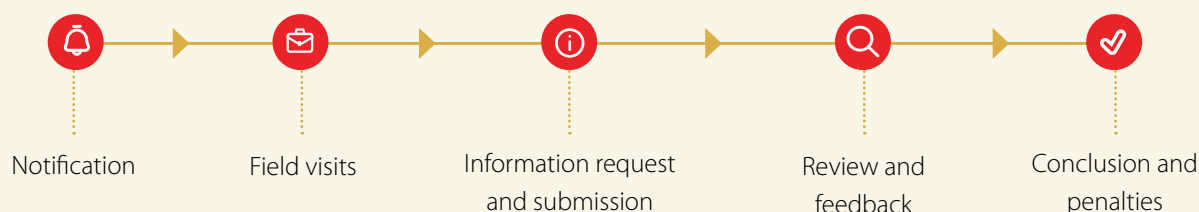
representatives who project confidence and honesty can tip the scale in the company's favor, especially when facing subjective judgment from authorities.

Best practices for managing interactions with tax officers

The way a business engages with tax officials during an audit can significantly affect the tone and outcome of the process. In general, a cooperative and transparent approach tends to yield more constructive results than a defensive or evasive stance. Based on our practical experience, the following best practices are recommended:

- **Foster a tone of professionalism and respect:** Set the tone early by maintaining clear, courteous, and consistent communication. Designate a primary spokesperson to handle all audit interactions and ensure messaging reflects a unified, professional stance. A respectful tone does not mean passive compliance—it signals that the company takes its obligations seriously and values constructive engagement.
- **Demonstrate transparency with intention:** Where issues are known or anticipated, address them proactively with clear explanations and evidence of corrective measures taken. This builds credibility and shows maturity in compliance management. However, resist the urge to over-disclose or speculate beyond the scope of inquiry, which may open new lines of scrutiny and dilute focus.
- **Leverage local and external expertise strategically:** Engaging local tax advisors who understand regional practices and language can smooth communication and help interpret auditor expectations. In complex or high-stakes cases, experienced external advisors bring objectivity, technical depth, and negotiation

Typical Processes of Tax Audits



Industry Focus of Tax Audits in China – Current Priorities and Emerging Trends

Industry	Audit frequency	Key reasons for attention	Trend outlook
Manufacturing	High	Longstanding audit priority; common issues with VAT and CIT compliance. Competitive pressures may drive risky behavior.	Expected to remain a key focus due to complex operations and potential compliance gaps.
Construction	High	High cash flow, long project cycles, and cross-regional operations make it prone to tax risks and evasion practices.	Continued close scrutiny expected, especially on regional project filings and contractor payments.
Services	Low (currently)	Historically fewer audits; simpler tax structures.	Rising importance in the national economy may lead to greater audit focus in the coming years.
E-commerce	Growing	Involving cross-border sales, difficult jurisdiction issues, and complex compliance challenges.	Expected to face stricter audits due to fast growth and evolving tax rules.
Financial services	Growing	Complex products and transactions create room for aggressive tax planning or evasion.	Increasing regulatory focus to curb misuse of financial instruments for tax avoidance.
High-tech enterprises	Increasing	Subject to tax benefits and incentives; growing audit attention to prevent misuse.	Likely to face more frequent audits to ensure compliance with preferential tax policy requirements.

skills to manage sensitive points of friction and de-escalate potential disputes.

- **Respond constructively to audit findings:** Not all audits will conclude without adjustments. When disagreements arise, companies should aim to clarify their position calmly and factually. In some cases—especially where the issue lies in interpretation or incomplete documentation—a cooperative approach and willingness to compromise may yield better results than prolonged contention.
- **Consider voluntary disclosures where appropriate:** If a potential noncompliance issue is identified before the authorities raise it, voluntary disclosure accompanied by prompt correction can help reduce penalties. Tax authorities often reward proactive behavior with more lenient treatment, particularly when transparency is paired with evidence of improved controls.
- **Remain solution-oriented when addressing differences:** Not all audit findings will align with the taxpayer's views. For issues that fall into interpretive gray areas or procedural uncertainty, a negotiated settlement may be more efficient than litigation or appeals. Being open to settlement signals pragmatism and a desire to resolve issues efficiently, rather than escalating them unnecessarily.

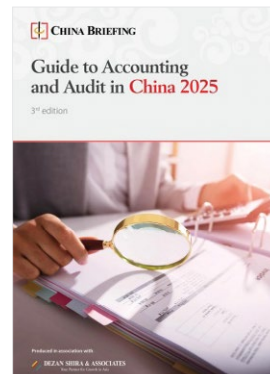
Key takeaways

Tax audits are a reality that every business must be prepared to face. By understanding what triggers audits, responding with discipline and precision, and fostering constructive relationships with tax officers, FIEs can navigate this process more effectively. When handled correctly, even a challenging audit can become an opportunity to enhance compliance systems, correct course where needed, and reinforce trust with regulators—an invaluable asset in the long-term success of operating in China. 📖



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Guide to Accounting and Audit in China 2025



With businesses operating in a growing volatile, unexpected, complex, and ambiguous (VUCA) world, financial health and compliance has become more important than ever.

More attention should thus be given to the audit and compliance procedures to reveal unexpected irregularities or suboptimal business practices, discover eligibility for tax incentives that had not previously been captured, as well as maximize efficiency within the organization.

In this Guide to Accounting and Audit in China 2025, we walk foreign businesses through the annual audit and compliance process from start to finish.

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Dezan Shira & Associates' tax advisors provide professional, hands-on support during tax audits and inquiries. We assist in preparing clear responses, organizing required documentation, and communicating with tax authorities to reduce risks and avoid unnecessary delays. For more information, please contact: china@dezshira.com.

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Resolving Tax Disputes and Minimizing Risks

Tax disputes in China can carry serious consequences. This chapter helps companies evaluate when to contest decisions through legal channels and how to reduce exposure during the dispute process.



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A tax dispute arises when the tax authority and a taxpayer (or withholding agent) disagree on the interpretation of tax rules, or the recognition of factual matters related to a tax obligation. These disagreements can emerge in routine compliance processes, tax audits, or when specific tax benefits or treatments are in question.

When managed effectively, resolving a tax dispute is not merely a defensive exercise—it is an opportunity to safeguard your company’s tax rights, clarify regulatory positions, and minimize unnecessary costs and business disruption.

As China continues to enhance legal and administrative transparency, businesses are increasingly equipped with mechanisms to pursue fair outcomes. The key lies in understanding how—and when—to deploy them.

This chapter outlines dispute resolution mechanisms and strategic considerations for businesses.

What constitutes a tax dispute?

In day-to-day business operations, tax disputes typically fall into the following categories:

Diverging interpretations of tax laws and regulations

Tax legislation often lags behind evolving business practices and cannot cover every commercial scenario in detail. As a result, differences in interpretation are common.

For example, one frequently disputed clause is Article 8 of the Corporate Income Tax Law, which allows for deductions of “reasonable expenses actually incurred and related to revenue generation.” In practice, determining what constitutes a “reasonable” and “revenue-related” expense can lead to diverging views.

Consider the case of meeting fees. Even if the costs are real and documented, tax authorities

may question their deductibility if the fees contain elements that could be classified as entertainment expenses. This could prompt scrutiny over the relevance and necessity of the expense, leading to deeper examination beyond standard thresholds or documentation requirements.

Disagreements over the recognition of facts related to a tax matter

Tax rules must be applied based on accurate facts. Disputes can arise when the tax authority and taxpayer disagree on the nature or classification of those facts.

For example, we have supported several high-tech enterprises facing challenges over their qualifications for High and New Technology Enterprise (HNTE) status. One eligibility criterion was that income from high-tech products or services must account for over 60 percent of total revenue. However, the definition of "high-tech products or services"—as guided by the HNTE Working Guidelines—requires that such income derives from innovation and R&D activities aligned with key national focus areas. Tax officials often apply heightened scrutiny to terms like "technological innovation," "R&D activities," or "technology-based income." Without sufficient evidence to substantiate these classifications, disputes may arise over the true nature of products, services, or income streams, making factual documentation and technical analysis essential.

Disputes over penalties or administrative actions following non-compliance

When a taxpayer engages in non-compliant behavior—either due to misunderstanding tax laws or deliberate intent—disputes may center on the severity of administrative penalties imposed.

For example, Article 63 of the Law on the Administration of Tax Collection (LATC) defines "tax evasion" as a serious offense but lacks an explicit requirement for proving intent. While the State Taxation Administration has clarified in case-specific replies that "subjective intent" is a necessary element, some local authorities adopt a stricter interpretation. For instance, if a company deducts business entertainment expenses that the tax authority later deems unrelated or unreasonable, what began as a disagreement over deductibility may escalate to an accusation of tax evasion. In such cases, taxpayers may face fines ranging from 0.5 to five times the underpaid tax—an outcome that often sparks secondary disputes over the classification and proportionality of penalties.

Selecting the right method for resolving tax disputes

To resolve tax disputes effectively and efficiently, businesses may adopt different strategies at each stage of the process. As each resolution method has its advantages and limitations, companies should select the most suitable approach based on their specific circumstances.

Responding during audit or inquiry prior to tax bureau's conclusion

When facing a tax dispute, the most strategic and cost-effective time to act is before the tax authority reaches a final conclusion—especially before the issuance of the tax audit report. Compared with post-audit appeals or litigation, this proactive approach is faster, less costly, and more likely to result in a favorable or negotiated outcome.

At this stage, if the taxpayer can proactively address every issue raised by the tax authority with detailed explanations and supporting documentation,

it can significantly influence the tax bureau's determination and mitigate potential penalties. For example, if tax authorities identify a red flag—such as employee average individual income tax (IIT) appearing low—taxpayers should review the basis of the calculation. Often, the authority may rely on rough averages or outdated data, while companies may have legitimate explanations such as part-time staffing structures or business seasonality. Providing precise payroll breakdowns or contractual terms can dispel misunderstandings.

In situations involving differences in policy interpretation, presenting an official interpretation from the central tax authority is critical. If no central guidance is available, practices from other local jurisdictions can also be cited, especially if they are beneficial and align with the taxpayer's situation.

Defense and request of a hearing when penalties are proposed

If the audit results in a proposed penalty, and the taxpayer receives a Notice of Tax Administrative Penalty, it is still possible to defend your position before the penalty is finalized. At this stage, two key options are available:

- **Submit a written statement or defense:** Taxpayers have the right to present a formal explanation addressing the factual background, legal reasoning, and any mitigating circumstances that may support a reduction or withdrawal of the proposed penalty.
- **Request a formal hearing:** Under the *Interim Measures for Implementing the Hearing Procedure on Tax Administrative Penalties* (the Measures), the tax authority is obligated to notify the taxpayer of their right to a hearing if the proposed penalty exceeds RMB 2,000 (approx. US\$276) for individuals or RMB 10,000 (approx. US\$1,380) for legal entities.

The hearing is a structured administrative procedure. During the hearing:

- The tax investigators present the alleged facts and legal basis for the penalty;
- The taxpayer (or their representative) may refute the claims, challenge the legal interpretation, and cross-examine evidence;
- A hearing officer presides over the process, ensuring both parties can fully present arguments and comment on the evidence; and
- Upon completion, the hearing officer issues a recommendation, which can influence the final decision of the tax authority.

Importantly, no tax payment or fine is required during the hearing process, as the penalty is not yet finalized.

According to Article 6 of the Measures, if the tax authority discovers errors or inconsistencies in its proposed penalty during or after the taxpayer's request for a hearing, it is required to revise its decision and explain the changes to the taxpayer.

Though not litigation, the hearing process grants taxpayers procedural rights comparable to those in court, including the right to defend, cross-examine, and make a final statement. This mechanism offers a valuable opportunity to resolve disputes with the tax authority before penalties become binding.

Administrative review or tax litigation

If a dispute cannot be resolved during the audit or hearing phase, taxpayers in China may pursue formal legal remedies through administrative review or administrative litigation. These avenues provide a framework for challenging the final decisions of the tax authorities, especially when the taxpayer believes there has been a misapplication of law or procedural injustice.

Administrative review is typically the first recourse after receiving a final decision from the tax bureau—such as an administrative penalty, an enforcement order, or a tax preservation measure. Taxpayers must submit the application within 60 days of receiving the contested decision. The review is usually conducted by the next-level tax authority (for example, a provincial office if the original decision was made at the municipal level). Before the review process can begin, taxpayers are generally required to either settle the disputed tax amount or provide an acceptable financial guarantee, such as a bank letter of guarantee or an insurance bond. The administrative review authority is obligated to issue a decision within 60 days, although an extension of up to 30 days may be granted under special circumstances. If the authority determines that the original decision was flawed—either in fact or in law—it can amend or revoke it. If the taxpayer is dissatisfied with the outcome, they may proceed to litigation.

Administrative litigation allows taxpayers to take the dispute to the People's Court for judicial review.

This step is more formal, involving public hearings, strict procedural rules, and legal representation. Litigation is typically filed with the Basic or Intermediate People's Court, depending on the level of the tax bureau that issued the disputed decision. Taxpayers may challenge a wide range of tax-related administrative actions, including the imposition of penalties, denial of tax benefits, enforcement actions, or even the failure of tax authorities to act. As with administrative review, the taxpayer is usually required to either pay or secure the disputed tax amount before the court will accept the case, although there are exceptions in certain procedural violation cases. A lawsuit must generally be filed within 15 days of receiving the administrative review decision—or in some cases, directly after the initial decision if administrative review is skipped as permitted by law. The latter should happen within six months from the date the taxpayer becomes aware of the administrative action.

While administrative litigation provides the most authoritative resolution mechanism and may result

Comparison of Tax Dispute Resolution Options				
Resolution option	Typical timeline	Cost level	Binding outcome	Notes
Internal negotiation	Short (1–3 months)	Low	No	May resolve minor misunderstandings or factual clarifications early.
Tax audit hearing	Medium (2–6 months)	Low to medium	No	Opportunity to present your position before tax authority conclusion.
Administrative review	Medium (2–6 months)	Medium	Yes (can appeal)	Mandatory for tax assessment disputes before litigation.
Administrative litigation	Long (6–18+ months)	High	Yes (final)	Requires payment or guarantee of disputed tax in advance.

Must a Taxpayer File for Administrative Review Before Litigation?

Under the *Law of the People's Republic of China on the Administration of Tax Collection* and related regulations, whether a taxpayer must first pursue administrative review before initiating litigation depends on the specific nature of the dispute. The rules generally fall into two categories:

1. Disputes requiring administrative review before litigation (tax assessment–related disputes)

Taxpayers must first file for administrative review in cases involving disagreements over a tax authority's assessment decisions.

These include disputes regarding:

- Determination of tax amounts payable;
- Calculation of late payment interest;
- Recognition of tax obligations;
- Classification of applicable tax categories;
- Application of relevant tax rates.

Only after the administrative review process is completed—and if the taxpayer remains dissatisfied—may the case be brought before a court.

2. Disputes where direct litigation is permitted (non-assessment–related disputes)

Some disputes can bypass administrative review and proceed directly to litigation. These typically involve administrative enforcement or inaction by tax authorities, such as:

- Penalties or fines imposed by the tax authority;
- Compulsory enforcement actions (e.g., freezing of accounts, seizure of assets);
- Tax preservation measures (e.g., inventory or property detention);
- Failure to respond to or process applications, including:
 - Requests for tax exemptions or reductions;
 - Applications for export VAT refunds;
 - Requests for tax credit offsets or refunds.

in a binding judgment, it involves higher financial and time costs. Therefore, many taxpayers—especially FIEs—carefully weigh the costs, risks, and likelihood of success before choosing this route. In practice, litigation is often used in cases involving significant financial exposure, contested legal interpretations, or to clarify ambiguous tax rules that may affect the taxpayer's broader business operations. 



TAX DISPUTE RESOLUTION

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