China Resource Tax Reforms to Roll out Nationwide

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On September 30, 2011, the State Council released revisions to the *Tentative Regulations of the People's Republic of China on Resource Tax*, *Regulations of the People's Republic of China on Sino-foreign Cooperative Exploitation of Ocean Oil Resources* and the *Regulations of the People's Republic of China on the Exploitation of Continental Oil Resources* (together the "**Revisions**"), which will take effect on November 1, 2011. The move comes as a major step in rolling out nationwide reforms in the levying of resource tax. These reforms were initially introduced as a pilot scheme in Xinjiang on June 1, 2010 and later extended to cover an additional 11 provinces/autonomous regions in western China.[1]

Resource tax reforms will significantly increase the tax burden for Chinese oil and gas companies, as they will now have to pay tax based on sales revenue (which have risen dramatically over the past decades) rather than volume. Under the new rules, the revenue-based tax will primarily target crude oil and natural gas, while the existing volume-based tax will still apply to coal, minerals and salt. The tax rate for rare earth and coking coal will increase or change altogether. The impact of these reforms on Sino-foreign cooperative explorations is more limited - they will also adopt the new resource tax, but such tax is not significantly different from the existing practice of tariffs being paid to the government by foreign invested exploration projects under the "in-kind tariff" regime on mining activities.

Sales-based Tax for Crude Oil and Natural Gas

Specifically, under the new rules, resource tax in relation to the production of crude oil and natural gas will be 5-10% of the sales revenue, depending on the "quality and exploratory circumstances" of the oil and gas fields. We have not seen any implementing rules being issued to explain how a particular tax rate will be determined. Under their response to questions from reporters dated October 24, 2011 ("**Q&A**"), the Ministry of Finance ("**MOF**") and the State Tax Authority ("**SAT**") did indicate that they will "temporarily" follow the 5% tax rate for the time being.

Under the volume-based levying regime, the tax rate has been between RMB 8 to 30 yuan per ton of crude oil, and between RMB 2 to 15 yuan per thousand cubic meters of natural gas. The volume-based tax was first adopted in 1993, which did not reflect the surging energy prices during the past two decades. The shift to a revenue-based form of taxation will mean for Chinese resource firms an increase in costs which cannot be freely passed on to customers, given that the pricing for such commodities is heavily regulated in China. In the Q&A, MOF and SAT emphasize that the new tax will impact the profitability of energy firms, but not burden the refineries, end users and consumers. This has already been tested in the western regions under the pilot scheme, where the prices of crude oil, processed oil and natural gas were not impacted, according to the Q&A.

The new rules will also require that part of the central government's tax revenue be redirected to local government coffers.

The tax for other types of resources remains volume-based. However, in a press release following the issuance of the Revisions, the Chinese government indicated that the resource tax reforms will be extended to other types of resources once the time is ripe.

Higher Tax Rates on Rare Earths and Coking Coal

For rare earth minerals, the new tax rate of between RMB 0.4 yuan and 60 yuan per ton will be imposed. Earlier this year, the authorities raised the rate to RMB 60 yuan per ton for light rare earth minerals, and RMB 30 yuan per ton for heavy or medium rare earth minerals. According to the Q&A, the Revisions confirm these rate hikes, and do not make further changes to the tax rates.

For coking coal, the Revisions provide for a range of tax rates specifically for coking coal, from the current flat rate of RMB 8 yuan per ton to RMB 20 yuan per ton. Tax rates for other types of coal remain unchanged.

[1] These include Chongqing, Sichuan, Guizhou, Yunnan, Shaanxi, Gansu, Ningxia, Qinghai, Inner Mongolia, Guangxi and Hubei.

Resource Tax Applicable to Sino-foreign Cooperative Exploitation

For foreign companies investing in the oil and gas sector, the new resource tax will replace the current in-kind tariff system in relation to the exploitation of onshore and offshore oil by Sino-foreign cooperative ventures. This marks China's latest efforts to further unify the tax regimes between domestic and international players, as the in-kind tariff is among the few vestiges of the bifurcated system since the introduction of the 2008 *Enterprise Income Tax Law*.

Under the existing rules, foreign-invested oil and gas fields are exempt from resource tax. Instead they are required to "deliver" a percentage of the oil or gas output to the Chinese government as an in-kind payment. In practice, however, companies do not physically deliver the oil or gas. They will normally sell the oil or gas on the market, and pay a tariff to the government from the sales proceeds. The amount of the tariff would equal the proceeds collected on the amount of oil or gas that would have otherwise been delivered to the government. Therefore, the tariff model is broadly similar to the new resource tax, as both reflect the price of the commodity actually sold on the market.

The in-kind tariff is progressive, with rates ranging from 2% (or 4% for oil fields located in Qinghai, Tibet, Xinjiang and shallow sea areas) to 12.5% for crude oil and from 1% to 3% for natural gas. The applicable rate depends on the scale of production, whereby large producers would be subject to the higher rates. However, crude oil producers are exempt from the mining tariff if their annual production does not exceed half a million tons (or one million tons for Qinghai, Tibet, Xinjiang and shallow sea areas). Natural gas producers are exempt if they do not exceed two billion cubic meters per annum. In comparison, the new resource tax does not offer an exemption for smaller producers. Further, the resource tax does not set progressive rates based on the scale of production, but is primarily based on the quality of the commodity instead.

Under the Revisions, Sino-foreign cooperative exploitation contracts entered into prior to November 1, 2011 will be grandfathered; they will be allowed to pay existing tariff rather than resource tax throughout the term of the contract even after the Revisions take effect.

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