1. Background

China has recently implemented a range of national policies and regulations aimed at tackling environmental concerns. As part of this effort, the Standing Committee of China’s National People’s Congress promulgated the Environmental Protection Tax Law (中华人民共和国环境保护税法) (the “New Law”) in late 2016, which will come into effect on January 1, 2018. The New Law will abolish – and replace with taxes – the existing system under which local environmental authorities were entrusted with collecting discharge fees on various pollutants.

a. The existing system

The existing pollutant discharge fee system was implemented more than 35 years ago as part of the 1979 Environmental Protection Law (Trial). Comprehensive administration regulations were issued in 2003, setting out detailed rules on the collection and use of pollutant discharge fees. However, this system has suffered from inherent weaknesses, the most notable being the limited enforcement by local environmental authorities and intervention by local governments. Chinese media have reported that there are major polluting enterprises in almost every Chinese city that have been exempted from paying discharge fees by local governments for policy reasons. Similarly, governments in Jiangxi and Guangdong Provinces have reportedly used public funds to pay discharge fees on behalf of high-revenue-generating enterprises established in their jurisdictions.

b. Origins of the new tax

The concept of an environmental protection tax was first raised in 2008 by the State Council. After years of research and discussion, the Ministry of Finance, the State Administration of Taxation, and the Ministry of Environmental Protection jointly issued an initial draft law to the public for comment in June 2015, followed by a revised draft in September 2016. The New Law was officially promulgated on December 25, 2016.

2. Highlights of the New Law
a. Targeted (and exempted) enterprises

Most enterprises operating within China are subject to emissions taxes under the New Law. The following enterprises are exempted, though:

- companies that directly emit taxable pollutants into centralized sewage and domestic waste treatment facilities established under relevant laws; and
- companies that store or dispose of solid wastes in facilities or places that meet national or local standards of environmental protection.

b. Taxable pollutants, rates, and exceptions

While drafting the New Law, there was significant discussion as to whether carbon dioxide pollutants should be treated as taxable pollutants in response to severe air pollution. As noted in another recent O’Melveny article, China has committed efforts to control greenhouse gas emissions and plans to launch a national carbon emission trading market. However, the New Law ultimately does not address carbon dioxide pollution. Instead, the New Law maintains the categories of pollutants set out under the existing discharge fee system as various categories of air pollutants, water pollutants, solid wastes, and industrial noise. Annexed to the New Law are a detailed “Environmental Tax Items and Rates Table” and a “Taxable Pollutants and Equivalent Values Table” (collectively, the “Rates and Values Tables”).

Although otherwise taxable, pollutants discharged under the following circumstances are exempted from environmental protection taxes under the New Law:

- Taxable pollutants that are emitted from agricultural production (excluding large-scale farming);
- Taxable pollutants discharged by mobile pollution sources, such as motor vehicles, railway locomotives, off-road mobile machinery, ships, and aircrafts;
- Taxable pollutants discharged by urban sewage centralized treatment and domestic waste centralized treatment sites that have been established in accordance with the law and do not exceed nationally- or locally-stipulated emission standards;
- Solid waste utilized by taxpayers in a multipurpose manner, complying with national or local environmental protection standards; and
- Other circumstances approved by the State Council.

c. Penalties for violations

Violations of the New Law will be addressed in accordance with applicable provisions of the Law of the People’s Republic of China on the Administration of Tax Collection, the Law of the People’s Republic of China on Environmental Protection, and other relevant laws and regulations. Among other potential
actions, relevant tax authorities will be authorized to take the following enforcement measures against enterprises in their jurisdictions that fail to pay applicable environmental taxes in accordance with the New Law:

(1) issue written notifications to banks and other financial institutions to withhold and remit the related amount of taxes owed by such enterprises from deposits held with such institutions; and

(2) impound, auction, or sell commodities, goods, or other property of such enterprises equal to any taxes.

3. Questions

a. How will the tax be monitored and administered?

One reform sought in the New Law to the existing system is to limit the ability of local authorities to provide special treatment to enterprises established in their jurisdictions. Provincial-level authorities will only be given limited discretion in their jurisdictions to determine and adjust the specific tax rates for certain air and water pollutants within defined ranges set out in the Rates and Values Tables. When proposing any such adjustments, the authorities are required to submit their suggested values for notice filing to the standing committee of the People’s Congress at the same level for approval the Standing Committee of the National People’s Congress and the State Council.

A related change under the New Law is that there will need to be close cooperation between tax and environmental protection authorities. The New Law provides that environmental protection and tax authorities will jointly establish a platform for tax-related information sharing and a work coordination mechanism. Both authorities are required to regularly deliver environmental protection-related information and environmental tax-related information to each other.

Relevant enterprises will be required to file declaration forms with their applicable tax authorities. Environmental protection taxes will be calculated on a monthly basis, and declared and paid quarterly. During this process, tax authorities will need to rely on local environmental protection authorities to monitor the pollutants discharged by companies in their jurisdictions in order to determine whether the declared amounts are accurate.

While the participation of China’s tax authorities (which have comparatively greater power than China’s environmental authorities) and the limitations placed on local governments to determine tax rates are generally viewed as positive measures to increase environmental compliance, whether the interplay of the authorities will actually prevent local authorities from effectively granting exceptions or otherwise shielding companies in their jurisdictions remains to be seen.

b. How will environmental protection taxes be used?
Under the previous discharge system, discharge fees formed part of local
government budgets, being allocated for environmental management and to
subsidize certain pollution prevention measures as well as control and
development projects.

The New Law is silent on how environmental pollution tax revenue will be used
and whether it will be treated as local or central government revenues, or if it
will be somehow split between local and central governments. This leaves
questions in terms of incentives to administer the tax program, as well as the
usefulness of funds raised under the program to improve the environment.

c. What should companies do to prepare for the New Law?

Companies operating in China should review the Rates and Values Tables to
identify whether they will be liable to pay environmental taxes under the New
Law, regardless of whether they currently pay discharge fees under the current
regime. Since provincial-level authorities will continue to have some discretion
to adjust tax rates, companies should also confirm the applicable rates with
relevant local authorities. Full compliance with the New Law is expected to be of
increased importance as any violation could be punished by both tax and
environmental protection authorities.

d. Implications for M&A in China

The New Law will also have implications for mergers and acquisitions involving
Chinese companies, and environmental compliance will become an increasingly
important area during due diligence. The New Law provides that the company
that discharges relevant pollutants is the party liable for corresponding
environmental protection taxes. As such, the acquirer of a Chinese company in
an equity deal would assume historic liability for any environmental protection
taxes and related penalties for previously unpaid taxes. The New Law is silent
on whether the acquirer of a plant acquired via an asset deal that had
previously discharged pollutants would assume liability for any unpaid taxes
owed by the prior owner, but in other situations where a seller has not paid
taxes or lacks resources to pay such taxes following an acquisition, there are
cases where China’s local tax authorities have sought to involve the buyer.

* O’Melveny additionally recognizes legal consultant Qianru Hong for her
valuable contribution in researching and drafting this article.

1. An unofficial English version of the law is available here; the law in Chinese is
available here.

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