Application for Administrative Reconsideration

Applicant: Fake Design Culture Development Ltd.

Address: No. 258 Caochangdi Village, Cuigezhuang Township, Chaoyang District, Beijing (Zip: 100015)

Legal representative: Lu Qing

Respondent: The Second Investigation Branch of Beijing Local Taxation Bureau

Application Items:

1. As the Notification of Beijing Local Taxation Bureau on Definition of Several Policy Business Issues on Enterprise Income Tax (Jing Di Shui Qi [2006] No. 526) that the respondent has cited is an illegal basis, we hereby apply for review of this regulation;

2. We request cancellation of the Written decision on administrative settlement of the Second Investigation Branch of Beijing Local Taxation Bureau (Er Ji Shui Ji Chu [2011] No. 63) issued by the respondent, in accordance with the law.

Facts and Reasons:

After the respondent's tax investigation into the applicant's taxation situation from November 29, 2011 to December 31, 2010, the respondent issued the Written decision on administrative settlement of the Second Investigation Branch of Beijing Local Taxation Bureau (Er Ji Shui Ji Chu [2011] No. 63) (hereinafter referred to as the *written decision on punishment*), requiring the applicant to make a supplementary payment of 508,633.05 yuan in business tax, 33,610.42 yuan in urban maintenance and construction tax, 15,258.99 yuan in education fees, 4,701,885.48 yuan in enterprise income tax, 4,368.67 yuan in stamp duty, and additional late fees of 416,144.88 yuan for underpaid business tax, 25,996.82 yuan for underpaid maintenance and construction tax, and

2,748,189.82 yuan for underpaid enterprise income tax.

The applicant believes that the decision on tax settlements made by the respondent on supplementary of taxes and imposing late fees on repaid taxes is wrong, due to the following reasons:

I. Procedural Errors

1. Early intervention by the public security department, joint action between the public security and taxation departments, making arrests before auditing, such procedures are in grave violation of the law.

(1) Facts

The applicant received a Tax Inspection Notice from the respondent for the first time on April 8, 2011. However, persons concerned including Ai Weiwei, Wen Tao and Hu Mingfen had already been detained by public security organs before this date. After April 8, 2011, the public security organs further detained Liu Zhenggang and Zhang Jinsong.

At 15:00 on April 8, 2011, the respondent and Beijing public security organs raided and seized all financial and accounting data from 2005 to 2010, including contracts, seals and other items belonging to the applicant. Meanwhile, the respondent interrogated Zhang Jinsong, the driver of Ai Weiwei, and wrote reports. For the first time, the Tax Inspection Notice and the Inquiry Notice were presented to the applicant, requiring Lu Qing, the applicant's legal representative, to visit the Beijing Local Taxation Bureau on April 12 for questioning.

At 9:30 on April 12, 2011, only after three raids and "disappearances" of five persons, the respondent conducted the questioned Lu Qing, the legal representative of the applicant, for the first time.

On May 20, 2011, Xinhua News Agency made a short announcement stating that "A company under the control of artist Ai Weiwei was found to have evaded "a huge amount" of tax, the Beijing police authorities said on Friday. The Beijing Fake Cultural Development Ltd. was also found to have intentionally destroyed accounting documents, the police authorities told Xinhua, citing an initial investigation." On the evening of June 22, 2011, after being detained for 81 days,

Ai Weiwei was released “on bail pending trial”. At 22:15 that night, Xinhuanet published a short message in both Chinese and English, "The Beijing police department said Wednesday that Ai Weiwei has been released on bail because of his good attitude in confessing his crimes as well as a chronic disease he suffers from. The decision comes also in consideration of the fact that Ai has repeatedly said he is willing to pay the taxes he evaded, police said. The Beijing Fake Cultural Development Ltd., a company Ai controlled, was found to have evaded a huge amount of taxes and intentionally destroyed accounting documents, police said". (http://news.xinhuanet.com/english2010/china/2011-06/22/c_13944511.htm)

The above facts demonstrate that the close cooperation between the respondent and the public security organs are directly related to the tax case of the applicant.

(2) Procedural mistake I: Early intervention of the tax evasion case by public security organs

According to paragraph 1, Article 201 of the Criminal Law of the People’s Republic of China as amended on February 28, 2009 (hereinafter referred to as Criminal Law), “Where any taxpayer files false tax returns by cheating or concealment or fails to file tax returns, and the amount of evaded taxes is relatively large and accounts for more than 10 percent of payable taxes, he shall be sentenced to fixed-term imprisonment not more than three years or criminal detention, and be fined; or if the amount is huge and accounts for more than 30 percent of payable taxes, shall be sentenced to fixed-term imprisonment not less than three years but not more than seven years, and be fined”, and paragraph 4, Article 201, “Where any taxpayer who committed the act as described in paragraph 1 has made up the payable taxes and paid the late fine after the tax authority sent down the notice of tax recovery according to law, and has been administratively punished, he shall not be subject to criminal liability, except one who has been criminally punished in five years for evading tax payment or has been, twice or more, administratively punished by the tax authorities”, tax administrative treatment has become a prepositional condition for the public security organs to initiate a judicial procedure.

According to Paragraph 1 of Article 57 of the Notice of the Supreme People’s Procuratorate and the Ministry of Public Security on Issuing the Provisions (II) of the Supreme People’s Procuratorate and the Ministry of Public Security on the Standards for Filing Criminal Cases under the Jurisdiction of the Public Security Organs for Investigation and Prosecution

promulgated on May 7, 2010, "【Tax evasion case (Article 201 of the Criminal Law)】For any tax evasion suspected of one of the following circumstances, a case will be filed for investigation and prosecution: (1) Any taxpayer files false tax returns by cheating or concealment or fails to file tax returns to evade taxes, with the amount of evaded taxes more than 50,000 yuan and accounting for more than 10 percent of payable taxes, does no make up the payable taxes and does no pay the late fine after the tax authority sent down the notice of tax recovery according to law, and refuses to be administratively punished; (2) Any taxpayer has been criminally punished in five years for evading tax payment or has been, twice or more, administratively punished by the tax authorities, and has evaded taxes, with the amount of evaded taxes more than 50,000 yuan and accounting for more than 10 percent of payable taxes; (3) Where any withholding agent fails to pay or fails to pay in full the withheld or collected taxes by cheating or concealment, and the amount is more than 50,000 yuan". The applicant was established on November 29, 2000, had no criminal and administrative punishment records before this tax case, and did not commit the actions of "failing to make up the payable taxes and failing to pay the late fine after the tax authority sent down the notice of tax recovery according to law, or refusing to be administratively punished". As the requirements for case establishment could not be met as described above, the respondent's act of cooperating with the public security department's early intervention, making arrests and inspecting taxes afterwards, is a grave violation of the law and an abuse of powers. Evidences obtained by means of violating proper procedures are illegitimate, therefore the decision for administrative punishment by which the respondent has made shall be withdrawn.

(3) Procedural mistake II: tax authorities and public security organs joining forces on case handling

According to Paragraph 1 of Article 11 of the Provisions on the Transfer of Suspectable Criminal Cases by Administrative Organs for Law Enforcement promulgated on July 9, 2001, "For any suspectable criminal cases that administrative organs for law enforcement were to transfer to the public security department, administrative punishments shall not serve as substitutes for the transfer", Paragraph 2, "Any warning or administrative punishment decisions such as orders to cease production or operation, suspension or revocation of permits, suspension or revocation of licences, made by the administrative organs for law enforcement before the transfer of a

suspectable criminal case to the public security organ shall not be discontinued", and Article 3, "According to the regulations of the administrative punishment law, before the transfer of a suspectable criminal case to the public security organs, when the people's court imposes a fine on the party at the occasion that an administrative organ has already made a previous decision, the amount of fine imposed by the former shall be made the same as that by the latter", a case that has already been established by a judicial institution shall not be handled additionally by the administrative organ unless it is a decision already made before the transfer. In accordance with this logic, if the public security organs have already been involved in the case, then the tax authorities shall withdraw from it; if the tax authorities are handling the case, it implies that the case has not been transferred to the public security department or the conditions for transfer are not met, then the public security department should not be involved in the case. It is not only a procedural mistake for the respondent and the public security organs to join forces in handling a case, it is also a serious confusion of administrative and judicial boundaries, thoroughly deviating from the legislative purpose of the "Provisions on the Transfer of Suspectable Criminal Cases by Administrative Organs for Law Enforcement". According to Paragraph 1 of Article 3 of the Criminal Procedure Law of the People's Republic of China, "The public security organs shall be responsible for investigation, detention, execution of arrests and preliminary inquiry in criminal cases. The People's Procuratorate shall be responsible for procuratorial work, authorizing approval of arrests, conducting investigation and initiating public prosecution of cases directly accepted by the procuratorial organs. The People's Courts shall be responsible for adjudication.", and Paragraph 2 of Article 3, "Except as otherwise provided by law, no other organs, organizations and individuals shall have the authority to exercise such powers.", the respondent has no authority to intervene at the investigation stage and any evidence collecting action during the investigation stage is illegal.

(4) Procedural mistake 3: The respondent has obtained evidence materials from the public security organs

The respondent claimed that some of its materials are taken from the public security organs.

Firstly, according to the aforementioned argument, early intervention by the public security organs is a breach of statutory procedures. Therefore, even if the public security organs hold

materials relevant to the case, the materials are illegitimate because of the procedural errors. Thus, any and all materials that the respondent obtained from public security organs should be deemed illegitimate.

Secondly, according to Article 70 of Several Provisions of the Supreme People's Court on Evidence in Administrative Procedures (Fa Shi [2002] No. 21), "Any fact identified by a valid judicial document of the people's court or verified by a document of the arbitration body can be used as basis for a verdict.", the materials collected by the public security organs as investigating authorities, which have not been confirmed by the people's court, shall not be used by the respondent as basis for a verdict.

2. Before the tax inspection, the respondent did not fulfill its obligations for notifications in accordance with the law

According to Article 22 (1) of the Tax Investigation Rules (Guo Shui Fa [2009] No. 157), "Before inspection, the inspected party shall be informed of the inspection time and materials to be prepared, unless prior notice impedes the inspection".

However, late at night on April 6, 2011, when there was no obstacle to inspection, the respondent failed to inform the applicant according to legal procedures and retrieved the accounting materials of the applicant from the founding time of the company, the year 2000, to February 2011, from Beijing Huxin Financial Accounting Services Co., Ltd. (hereinafter referred to as Huxin Company), to which the applicant entrusts for bookkeeping.

3. The respondent failed to present a tax inspection certificate and the Tax Inspection Notice in accordance with the law

According to Article 59 of The Law of the People's Republic of China Concerning The Administration of Tax Collection (hereinafter referred to as 'Tax Administration Law') "When conducting tax inspection, the officials sent by the tax authorities shall produce tax inspection

certificate and tax inspection notice, and shall have the duty to keep confidentiality for the persons under inspection; where no such certificate and notice are produced, the persons subject to inspection shall have the right to refuse to accept the inspection" and Article 22 (2) of the Tax Investigation Rules (Guo Shui Fa [2009] No. 157), "The inspection shall be executed by two or more inspectors, who should show the inspected object the tax inspection certificate and the Tax Inspection Notice", it is a necessary legal procedure for the tax inspectors to show the inspected party the certificates and tax legal documents.

However, late at night on April 6, 2011, when retrieving accounting materials from Huxin Company, the respondent failed to present the tax inspection certificate and the Tax Inspection Notice, hence violating the legal procedure.

4. The respondent was in grave violation of legal procedures when retrieving the applicant's accounting information

According to Article 25 of the Tax Investigation Rules (Guo Shui Fa [2009] No. 157), "When retrieving account books, accounting vouchers, statements and other relevant information, one must present the Notice for Retrieval of Accounting Materials to the inspected party and fill out the List of Retrieved Accounting Materials, which shall be signed for confirmation after being checked with the inspected party.

However, when retrieving accounting materials from Huxin Company and the applicant, the respondent failed to present the Notice for Retrieval of Accounting Materials and to fill out the List of Retrieved Accounting Materials, which had not been checked with the applicant.

5. The respondent had not returned retrieved account materials belonging to the applicant within the statutory time limit

According to Article 86 of Rules for the Implementation of the Law of the People's Republic of China on the Administration of Tax Collection (hereinafter referred to as *Tax Adminstration Rules*), "A taxation authority exercising its powers of office provided under the provisions of item (1) of Article 54 of the Tax Administration Law may do so at the business premises of a taxpayer or tax-withholding agent. If deemed necessary and subject to approval by the head of a taxation

authority at county level or above, the taxation authority may also demand that the taxpayer's or tax withholding agent's account books, accounting documentation, statements and other relevant materials of the previous accounting year be submitted for examination. When doing so, however, the taxation authority must provide the taxpayer or tax withholding agent with a detailed list of the items taken and shall return them within three months; in special cases, and subject to approval by the head of a taxation authority at city and autonomous prefecture level or above, the taxation authority may take back the taxpayer's or tax withholding agent's account books, accounting documentation, statements and other relevant materials of the current accounting year for examination, which must be returned by the taxation authority within 30 days", and Article 25 (2) of the Tax Investigation Rules (Guo Shui Fa [2009] No. 157), "Retrieval of the taxpayer's or tax withholding agent's account books, accounting documentation, statements and other relevant materials of the previous accounting year shall be approved by the head of a taxation authority and they shall be returned within three months; retrieving of the taxpayer's or tax withholding agent's account books, accounting documentation, statements and other relevant materials of the current accounting year shall be subject to approval by the head of a taxation authority at city and autonomous prefecture level or above and they must be returned within 30 days", any accounting materials of the previous accounting year retrieved by the respondent from the applicant shall be returned completely within three months; any accounting materials of the current accounting year retrieved by the respondent from the applicant shall be returned within 30 days.

However, the respondent did not return all the retrieved accounting materials according to the law when the statutory time limit has expired, and as of now, they still have not been returned. It does not only affects the applicant's production and business activities seriously, it also substantially impedes the applicant's rights to an administrative review.

Considering the above, and subjected to Paragraph 1(c) of Article 28 of the Administrative Reconsideration Law of the People's Republic of China (hereinafter referred to as Administrative Reconsideration Law), "If a specific administrative act has been undertaken in one of the following circumstances, the act shall be annulled, altered, or confirmed as illegal by decision; if the specific administrative act is annulled or confirmed as illegal by decision, the applied may be ordered to undertake a specific administrative act anew within a fixed time: 3. violation of legal

procedures; 4. excess of authority or abuse of powers", Article 45 of the Regulation on the Implementation of the Administrative Reconsideration Law of the People's Republic of China, "Where a specific administrative action is under any of the circumstances set forth in Paragraph 1 (c) of Article 28 of the Administrative Reconsideration Law, an administrative reconsideration organ shall decide to revoke or modify the specific administrative action or confirm the specific administrative action as a violation of law", and Article 55 of the Rules for Taxation Administrative Reconsideration (No. 21 Decree of the State Administration of Taxation), "The administrative reconsideration agency shall examine the legitimacy of the evidences in the following respects according to the specific situations of a case:

(1)Whether the evidences conform to the legal form; (2)Whether the obtaining of evidences conforms to the provisions of laws, regulations and judicial interpretations; and (3)Whether there are other circumstances in violation of laws which may affect the force of evidences", and Article 58 "The following evidentiary materials shall not be used as the basis for determination of a case:

(1) Any evidentiary material collected by any means in violation of legal procedures", the punishment decision made by the respondent to the applicant should have sufficient evidence; and such evidence should have legitimacy, including that they were to be obtained through legal procedures; furthermore, if the respondent collects evidence in violation of legal procedures, such evidence shall not be used as the factual basis for specific administrative act; moreover, if the respondent commits an action in violation of legal procedures when implementing the specific administrative act, its specific administrative act shall be revoked according to law. In terms of the respondent in the present case, its law enforcement has committed serious violation of legal procedures and excess of authority or abuse of powers, and thus its penalty decision should of course be revoked according to law.

It is due to the presence of violations in procedures, that the applicant has no access to its accounting records and to verify data. It has substantially impeded the applicant's rights to present its case and to defend itself against the facts as claimed in the written decision of punishment that the respondent has issued to the applicant. If there is no justice in procedures, it is tantamount to stripping off the other party's right to speak, and is equivalent to tolerating power abuse on the part of administrative institutions. The applicant strongly urges the institution in charge of the

reconsideration to exercise justice in its procedures, to return financial and accounting records to the applicant, in order to provide the most basic conditions for the applicant to develop its position based on facts. This is a civilized society, and this is the basic bottom line for “civilized people” to carry out “civilized law enforcement”.

II. Violations in legal basis applied for the written decision for settlement

Item 2(4) of the settlement decision in Part 2 of the “Settlement Decision” states that “According to Articles 1, 2, 3, 4 and 5 of the Provisional Regulations of the People's Republic of China on Enterprise Income Tax, Articles 1, 4, 5 and 6 of the Law of the People's Republic of China on Enterprise Income Tax, Article 5 of the Notification of Beijing Local Taxation Bureau on Definition of Several Policy Business Issues on Enterprise Income Tax (Jing Di Shui Qi [2006] No. 526), your company shall repay 4701885.48 yuan in enterprise income tax.”

The above-stated Article 5 of the Notification of Beijing Local Taxation Bureau on Definition of Several Policy Business Issues on Enterprise Income Tax (Jing Di Shui Qi [2006] No. 526) stipulates that "If in a tax inspection, a company has been found to have hidden income and repayment of the enterprise income tax is required, the method for calculation of the enterprise income tax to be repaid is: the hidden income, minus the turnover tax to be repaid and identifiable undeducted costs and expenses matching this part of income, should be used as the income for repayment of tax, and is multiplied by the enterprise income tax rate of the inspection year to figure out the amount of enterprise income tax to be repaid”.

The above (Jing Di Shui Qi [2006] No. 526) document does not have legitimacy.

1. The Beijing Local Taxation Bureau does not have the right to interpret the definition of a “tax inspection”.

The regulations on "Tax Inspection" come from Chapter 4 “Tax Inspection” of the Tax Administration Law enacted by NPC Standing Committee. According to Article 93 of the Tax Administration Law, “The detailed rules for implementation of this Law shall be formulated by the State Council in accordance with this Law", the State Council may interpret the “Tax Inspection” by formulation of detailed rules. Therefore, Beijing Local Taxation Bureau is not an appropriate body to explain "Tax Inspection".

Even if based on Paragraph 3, Article 85 of the Rules for the Implementation of the Law of the People's Republic of China on the Administration of Tax Collection, "The specific measures for tax inspection shall be formulated by the State Administration of Taxation", Beijing Local Taxation Bureau is not an appropriate main body to explain "Tax Inspection" either.

2. The Beijing Local Taxation Bureau does not have the right to interpret the "Method for calculating enterprise income tax"

According to Article 19 of the Provisional Regulations of the People's Republic of China on Enterprise Income Tax (hereinafter referred to as Provisional Regulations on Enterprise Income Tax) implemented before January 1, 2008, "The Ministry of Finance shall be responsible for the interpretation of these Regulations. The rules for the implementation of these Regulations shall be determined by the Ministry of Finance", the "Method for calculating enterprise income tax" shall be interpreted by the Ministry of Finance instead of by Beijing Local Taxation Bureau. Even if based on Article 59 of Provisional Regulations on Enterprise Income Tax, "The detailed rules are interpreted by the Ministry of Finance or by the State Administration of Taxation", the "Method for calculating enterprise income tax" shall not be interpreted by Beijing Local Taxation Bureau.

According to Article 59 of the Enterprise Income Tax Law of the People's Republic of China promulgated on January 1, 2008 (hereinafter referred to as the Enterprise Income Tax Law), "The State Council shall formulate a regulation on the implementation of this Law", the respondent applies its Jing Di Shui Qi [2002] No. 526 Document to the situation after January 1, 2008, meaning that it has interpreted the Enterprise Income Tax Law in lieu of the State Council.

3. Jing Di Shui Qi [2002] No. 526 Document conflicts with a higher-level law

The regulation of Article 5 of Jing Di Shui Qi [2002] No. 526 Document, "The hidden income, minus the turnover tax to be repaid and *identifiable* undeducted costs and expenses matching this part of income, should be used as the income for repayment of tax" is mistaken.

According to Article 5 of the Enterprise Income Tax Law, "The balance after deducting tax-free incomes, tax-exempt incomes, all deduction items as well as permitted remedies for losses of the previous year(s) from an enterprise's total amount of incomes of each tax year shall be the taxable amount of incomes" and Article 8, "The reasonable disbursements that are actually

incurred and in which have actual connection with the business operations of an enterprise, including the costs, expenses, taxes, losses, etc., may be deducted in the calculation of the taxable amount of incomes" and Article 9 of the Regulation on the Implementation of the Income Tax Law of the People's Republic of China, "The calculation of the taxable amount of an enterprise shall be based on the principles of the accrual method of accounting. The current incomes and expenditures shall be treated as current incomes and expenditures notwithstanding whether they have been received or paid; incomes and expenditures that are not current shall not be treated as current incomes and expenditures even the payment in question has been currently made, unless it is otherwise provided for by the present Regulation or the competent department of treasury or taxation of the State Council.", the basis for calculation of income tax shall be "taxable amount" instead of the concept of "repayable income" created by Jing Di Shui Qi [2002] No. 526 Document. In calculation of "taxable amount", relevant and reasonable expenditures including costs, expenses, losses and other expenditures shall be deducted, instead of the so-called "matching" two items "costs and expenses" in Jing Di Shui Qi [2002] No. 526 Document; The calculation of "the taxable amount" of an enterprise shall be based on the principles of the accrual method of accounting. The current incomes and expenditures shall be treated as current incomes and expenditures notwithstanding whether they have been paid, and shall not be based on the so called man-made "identifiable" principle in Jing Di Shui Qi [2002] No. 526 Document. If Jing Di Shui Qi [2002] No. 526 Document is based on, it is inevitable that the costs, expenses, losses and other expenditures of the applicant cannot be reflected on a complete, true and accurate basis, and balance is lost between rights and liabilities.

According to the Legislation Law of the People's Republic of China, Jing Di Shui Qi [2002] No. 526 Document is neither a law, a statute, nor a rule but a regulation of a working department of the local people's government. According to Paragraph 1, Article 7 of the Administrative Reconsideration Law, a citizen, legal representative or any other organization believes that an administrative organ has violated any of the following provisions in their administrative action may concurrently lodge an application to the administrative reconsideration organ for a review of such provision with an application for administrative reconsideration of the specific administrative action: (2)Regulations of people's governments above county level and their working

departments", Jing Di Shui Qi [2002] No. 526 Document that the respondent is base on has posed very serious influence on the interests of the applicant, thus the applicant lodges an application for a review of Jing Di Shui Qi [2002] No. 526 Document by law.

III. Wrong collection methods

The presence of procedural hindrance renders the applicant unable to have the so-called "facts" verified in the Settlement Decision. Regardless of "whether the fact of a legal violation exists", in terms of the collection method alone, according to the basis cited by the respondent in the Settlement Decision, the respondent uses "audit collection" method instead of "verification collection". The applicant believes that there are errors in the method that the respondent has used.

1. Insufficient preconditions for "audit collection"

According to Paragraph 4 of Article 201 of the Criminal Law, before the tax authorities issue a recovery notice to settle taxes, the public security department cannot intervene in any case of "evasion of tax payment" (i.e. "Tax Evasion" in Article 63 of the Tax Administration Law) in advance. The reason for early intervention by the public security department in this case is limited to "hiding and intentional destruction of accounting vouchers, account books and financial and accounting reports." The respondent also claimed its materials coming from the public security department, this indicating that the account books obtained by the respondent are incomplete materials, and tax collection based on incomplete accounting records is clearly insufficient for the requirements of an "audit collection".

2. When accounting records are incomplete, the "verification collection" method should be applied, and only such method may be applied, in accordance with the law

According to Article 35 of the Tax Administration Law, "If a taxpayer is under one of the following circumstances, tax authorities shall have the power to assess the amount of tax payable by him：(4) where account books are established, but the accounts are not in order or information on costs, receipt vouchers and expense vouchers is incomplete, making it difficult to check the books", and Article 3 of Measures for Verification Collection of Enterprise Income Tax (for Trial Implementation) (Guo Shui Fa [2008] 30) "If a taxpayer is under one of the following circumstances, tax authorities shall have the power to verify the enterprise income tax ：(4) where

account books are established, but the accounts are not in order or information on costs, receipt vouchers and expense vouchers are incomplete, making it difficult to check the books", the respondent should use the method of "verification collection" instead of using "audit collection" mistakenly.

Verification collection shall be applicable to such situation. This is not only prescribed in the Measures for Verification Collection of Enterprise Income Tax (Tentative) (Guo Shui Fa [2008] No. 30), similar regulations are also implemented in other taxation department in their tax collection practices. For example, Article 4 of the Circulation of Beijing Local Taxation Bureau on Printing and Distributing the Provisional Measures of Beijing Local Taxation Bureau on Verification Collection of Enterprise Income Tax (Jing Di Shui Qi [2004] No. 569) prescribes that "If a taxpayer for the enterprise income tax within the collection range of the local taxation bureau of the city is under one of the following circumstances, ***the verification collection*** shall be used to collect enterprise income tax: (4) where account books are established, but the accounts are not in order or information on costs, receipt vouchers and expense vouchers is incomplete, making it difficult to check the books". Although this document has been repealed, its specific requirements and situations for "Verification Collection" are interconnected with the above Measures for Verification Collection of Enterprise Income Tax (Tentative) (Guo Shui Fa [2008] No. 30). For another instance, Article 5 of the Interim Measures of Guangzhou Local Taxation Bureau on Verification Collection of Enterprise Income Tax (Shui Di Shui Fa [2005] 297) clearly states that, "If a taxpayer is under one of the following circumstances, tax authorities shall have the power to assess the amount of tax payable：(3) where account books are established, but the accounts are not in order or information on costs, receipt vouchers and expense vouchers is incomplete, making it difficult to check the books, including: 1. Where total income can be only checked accurately or verified, but its expenses and expenditures cannot be checked accurately; 3. Total income, costs and expenses cannot be checked properly, and true, accurate and complete tax information cannot be submitted to the tax authorities in charge, causing it difficult to be verified'. Hence, where the total income can be ascertained but costs, expenses and expenditures cannot be accurately checked and ascertained, and total income, costs, expenses and expenditures cannot be accurately checked and ascertained, the "verification collection" method should be applied, and only such method

may be applied. The “audit collection” shall not apply and is in fact invalid for the case.

3. The respondent fails to verify the objective costs, expenses, losses and other reasonable expenditures of the applicant through the “audit collection” method

In this case, the respondent has determined that “there are 15823724.36 yuan in design fees and engineering income that were not recorded in the account books” “between November 29, 2000 and December 31, 2010”, and used it as the basis for calculation of repayment of business tax, urban maintenance and construction tax, education surtax, and enterprise income tax. Regardless of whether the applicant’s total income as determined by the respondent as relevant to the corresponding items is accurate or not, or whether they exist or not, it is obvious that the respondent has not checked the costs and expenses of the items used to identify income.

According to Part (5), Article 1 “Legal Facts” of the Settlement Decision, the respondent has determined that the applicant has, in 2002, “enterprise income tax payable of 318590.85 yuan, and paid enterprise income tax of 4008.77 yuan” ; in 2003, “enterprise income tax payable of 33115.57 yuan, and paid enterprise income tax of 1128.38 yuan”; in 2006, “enterprise income tax payable of 1191377.86 yuan, and paid enterprise income tax of 2301.18 yuan” ; in 2007, “enterprise income tax payable of 1954777.47 yuan, and paid enterprise income tax of 14571.54 yuan” ; in 2008, “enterprise income tax payable of 1071895.35 yuan, and paid enterprise income tax of 9600.42 yuan” ; in 2009, “enterprise income tax payable of 172493.33 yuan, and paid enterprise income tax of 8754.66 yuan”. According to this calculation, the total amount of enterprise income tax underpaid by the application as determined by the respondent is 15,437,018.88 yuan, which has a discrepancy of only 386,705.48 yuan from 15823724.36 yuan, the applicant’s unrecorded income as determined by the respondent. Following this logic, the applicant’s projected income as determined by the respondent is 15823724.36 yuan, while its incurred costs, expenses and expenditures is only 386,705.48 yuan. In other words, the applicant’s gross profit from relevant projects is as high as 97%, which is ridiculous and peremptory.

The above data has sufficiently explained that the respondent has not ascertained the reasonable expenditures such as costs and expenses corresponding to the so-called projected income of 15823724.36 yuan. It has used the above-mentioned Jing Di Shui Qi [2002] No. 526

Document as cover, and hastily used 386,705.48 yuan as "identified" by the respondent as deduction.

Since the respondent is unable verify corresponding costs and fees, it should strictly follow regulations concerning "verification collection" as explained in relevant laws and normative documents such as the Tax Administration Law and the Measures for Verification Collection of Enterprise Income Tax (Tentative) (Guo Shui Fa [2008] No. 30), and should not forcibly use the "audit collection" method to attain an established goal.

4. Whether in "verification collection" or "audit collection", the respondent should verify the applicant's expenditures reasonably

When tax authorities perform an audit, apart from actively ascertaining facts that a taxpayer may be concealing its income, they are also responsible for identifying the facts of the taxpayer such as costs, expenses, taxes, losses and other expenditures related to production and management.

For example, Paragraph (3), Article 1 of the Reply of Inner Mongolia Autonomous Region Local Taxation Bureau on Several Business Issues about Income Tax (Nei Di Shui [2006] No. 180) states, "The problems about failure of the enterprise to account for raw materials and bookkeeping in IOUs due to inability to get invoices. In the Signature Procedure for Problems about Pretax Deduction for Failure of Taxpayers to Obtain Invoices after Purchase of Raw Materials", the Income Tax Management Department of the State Administration of Taxation proposes the following suggestions on treatment: Where invoices are used on an irregular basis, but economic operations did indeed occur, and expenses concerned are also within the range of allowable deduction, the tax authorities may demand the taxpayer to provide formal invoices or ***other proper evidence that can sufficiently prove authenticity of the expenses and to calculate the amount of expenses accurately; even if the taxpayer cannot provide relevant evidences, the tax authorities are responsible for verifying the amount and proportion of relevant expenses through other reasonable methods"***. Therefore, according to the regulations of the State Administration of Taxation as entailed by the Inner Mongolia Autonomous Region Local Taxation Bureau, the tax authorities have the responsibility to ascertain the specific amounts of costs,

expenses, losses and other expenditures that are related to the taxpayer's production and management. Even if the taxpayer does not provide normative invoices for relevant costs and expenses, but can provide "***proper evidence*** that is able to prove the authenticity of expenses and to calculate the amount of expenses accurately", such as business contracts, payment vouchers, payment receipts, and witness testimonies from the payee, the tax authorities shall recognize such costs and expenses. If the taxpayer fails to provide relevant evidence, the tax authorities still have responsibilities to "verify" relevant costs and expenses in a reasonable manner and shall not regard them as unincurred costs following the "audit collection" method, or "confirm" the costs on their own.

IV. "Decoration" income is not taxable for the applicant

The respondent ascribes "decoration income" to the applicant. Regardless of its main body, only in terms of the nature of the income, it shall not be deemed taxable even if it is ascribed to the applicant.

1. As the applicant does not have the construction enterprise qualification certificate for "a decoration and renovation enterprise for accepting internal decoration or residential renovation projects", it is impossible to obtain "decoration income".

According to Article 22 of the Measures for Management of Internal Decoration (Ministry of Construction, Order No. 110), "A decoration and renovation enterprise undertaking internal decoration projects must be subjected to a qualification review by the competent department of construction administration, obtain a corresponding construction enterprise qualification certificate, and undertake projects within the allowable range of its qualification level". The applicant does not belong to the range of construction enterprises as described above, and has no corresponding qualification, i.e. it has no right and ability to gain any "decoration income".

2. If the respondent insists on ascribing the income to the applicant, then the income can only be categorized as "illegal income".

On the "taxability" of illegal income, regardless of the academic debate involved, one can easily make a judgment in accordance with the "statutory" principle as outlined in the established legal system of China. According to Article 4 of the Tax Administration Law, "Units and

individuals that are obligated to pay tax as prescribed by laws or administrative regulations are taxpayers", and Article 37 "Where a taxpayer engaged in production or business operations or a taxpayer temporarily engaged in business operations fails to complete the formalities for tax registration in accordance with regulations, the tax authorities shall assess the amount of tax payable by him and order him to make the payment; if he fails to do so, the tax authorities may seize the commodities or goods of equivalent value to the amount of tax payable; if he pays the amount of tax payable after the seizure, the tax authorities shall immediately release the seizure and return the seized commodities or goods; if he still fails to pay the amount of tax payable after the seizure, the seized commodities or goods shall, upon approval of the commissioner of the tax bureau (or sub-bureau) at or above the county level, be auctioned or sold off in accordance with law and the proceeds shall be used to offset the amount of tax payable". The Tax Administration has only stated tax collection authority over "illegal income" that is a result of unlicensed operations. Beyond this situation, there is no further regulation or law for tax collection, and it cannot be expanded freely. Obviously, action that is "beyond operation range" is not equivalent to an action of "not handling tax registration according to regulations" as stated in Article 37 of the Tax Administration Law.

3. The tax authorities' treatment of such actions has surpassed their own functional range and violates the administrative powers of other functional departments

According to Article 6 of the Construction Law of the People's Republic of China, "The department in charge of construction administration under the State Council shall exercise unified supervision and regulation over construction activities of the whole country", and Paragraph 3 of Article 65, "An organization which is hired for projects without a certificate of qualification shall be outlawed and be fined, with all its illegal incomes confiscated". Even if according to the respondent's logic that such income is ascribed to the applicant, the income of "an organization which is hired for projects without a certificate of qualification" shall be managed and punished by the administrative departments of construction under the State Council instead of tax authorities.

V. Lack of legal content in the Settlement Decision

According to Article 56 of the Tax Investigation Rules (Guo Shui Fa [2009] No. 157), the Tax Settlement Decision shall include the following major contents: (6) Tax overdue time, calculation method for late fee, payment due date and place".

However, in the "2(6) Late fee" section, Part 2 "Settlement Decision" of the Tax Settlement Decision, the respondent only clarifies the legal basis (i.e. Article 32 of the Tax Administration Law), but does not define "Tax overdue time" and "method for calculation of late fee", making it difficult for the applicant to comprehend the late fee amounts of "416144.88 yuan", "25996.82 yuan", and "2748189.82 yuan".

In summary, to safeguard the legitimate rights and interests of the applicant, to keep the tax payment relation between tax authorities and enterprises, and to maintain authority, equality and fairness of national tax laws and tax law enforcement, your bureau is kindly asked to review the Notification of Beijing Local Taxation Bureau on Definition of Several Policy Business Issues on Enterprise Income Tax (Jing Di Shui Qi [2006] No. 526) on which the respondent has based its decision, to verify the facts and according to law, withdraw the Administrative Punishment Decision of the Second Investigation Branch of Beijing Local Taxation Bureau (Er Ji Shui Ji Chu [2011] No. 63)

Hereby undersigned, for the

Beijing Local Taxation Bureau

Applicant: Fake Design Culture Development Ltd.

Legal representative: Lu Qing

January 12, 2012