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Tax fraud does not pay

In brief

- China's State Taxation Administration (STA) recently uncovered four tax fraud cases involving fabricated R&D expenses to claim tax incentives.
- This article examines the details of these scams, highlighting how exploiting such loopholes not only renders businesses ineligible for tax benefits but also exposes both companies and their executives to significant legal and tax risks.

Feedback

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In detail

STA recently publicized four revealing cases of tax fraud, publicly naming the companies involved. These cases demonstrate systematic schemes to inflate R&D expenses — including fabricated projects, fictitious staff, and falsified expense records — all designed to illegally claim corporate income tax (CIT) and VAT incentives.

China's current tax legislation offers lucrative R&D tax incentives to spur innovation, including a super deduction policy that allows 100-220% extra tax deductions on qualifying R&D expenses, with high-tech enterprises qualifying for a reduced 15% CIT rate (versus the standard 25%).

The analysis below details the specific violations and key audit findings in these fraudulent schemes.

1 Case 1: "Moonlighting" staff

Paying one man for two jobs? A coal mining company in Shaanxi province found itself in hot water when tax authorities discovered an unusual case of "double-dipping" fraud. The company had been inflating its R&D costs by a staggering CNY 13.39 million, cleverly disguising the scheme by reporting the same employees for two separate jobs. This creative accounting led to a suspicious 65% drop in CIT payments. Ultimately, the fraudster faced a CNY 1.85 million (USD 254,745) penalty ticket.

The illegal tricks:

- Faking thirteen R&D personnel who were from other departments;
- Falsifying working hours and records of R&D personnel; and
- Conflating R&D expenses with production costs.

2 Case 2: “Phantom” engineers

Rising payroll while under-hiring? A Ningbo-based IT company raised red flags when it reported massive engineering costs that did not match its shoestring operation. A tax audit revealed the truth: the company had inflated R&D expenses to fraudulently reduce its CIT burden. The scheme backfired spectacularly, resulting in the recovery of CNY 1.5 million (USD 206,550) in back taxes and penalties.

The illegal tricks:

- Falsifying the hiring of R&D engineers who were customer service staff in disguise;
- Faking R&D expenses (which were service fees, software fees, bandwidth fees and traffic fees).

3 Case 3: “Vaporized” losses

Making money while reporting losses? An applied materials production firm in Shenzhen was caught red-handed by tax big data analysis for its above-peer-level R&D expenses. The investigation revealed CNY 80 million in fabricated gold inventory impairments — a glaring red flag, given gold's minimal natural loss rate during refining. As a result, the firm was required to repay CNY 52.3 million (USD 7.2 million) in back taxes and penalties.

The illegal tricks:

- Fabricating inventory (gold) impairments, despite gold's chemical stability and low scrap rate;
- Faking gold consumption costs in seventeen R&D projects where gold was not technically needed.

4 **Case 4: “Exhausted” labor**

Researching hard for nothing? A Jiashan-based cement manufacturer was flagged as a high-risk target in a tax big-data analysis - the company had claimed CNY 6 million in R&D tax deductions since 2019, yet produced zero intellectual property. During an onsite inspection, investigators made a telling discovery: what the company listed as an "R&D center" was, in reality, an equipment storage room. This sham operation resulted in CNY 3 million in unpaid VAT and CIT. The consequences were severe: authorities imposed a total penalty of CNY 6 million (USD 826,000), covering back taxes, late fees, and additional fines.

The illegal tricks:

- Double counting R&D expenses (CNY 2 million/year), which produced no results nor records;
- Faking R&D activities without equipment usage or innovation (using off-the-shelf materials instead);
- Concealing sales revenue (CNY 3.2 million) via personal accounts and off-book transactions.

WTS China’s observation

Chinese tax authorities are ramping up efforts to crack down on improper R&D tax deduction claims through advanced cross-data analysis and rigorous onsite inspections. Their scrutiny targets anomalies in three key areas: R&D project initiation, cost accounting practices, and expense allocation methodologies.

A particularly high-risk pattern has emerged — the "no results + high R&D expense + high fluctuation" profile. Cases fitting this pattern often reveal telltale warning signs: recycled documentation across projects, disproportionate cost distributions, and absence of substantive innovation. These indicators now serve as clear audit triggers, prompting deeper investigations.

Many compliance challenges stem from fundamental misunderstandings — companies frequently misinterpret policy boundaries, mismanage project governance requirements, or improperly attribute costs. Compounding these issues, insufficient documentation leaves the firms vulnerable when defending their deduction claims.

Companies enjoying or seeking to enjoy R&D tax incentives should strengthen internal controls, maintain full-cycle records, establish a clear evidentiary trail, and, most importantly, conduct regular and independent reviews.

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