

Tax Analysis

PRC Tax

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New rules issued on taxation of foreign company's representative office in China

On 20 February 2010, the State Administration of Taxation (SAT) issued a circular entitled "Tentative Measures for the Administration of Taxation on Representative Offices of Foreign Enterprises" (Guoshuifa [2010] No.18 (Circular 18)), to clarify and update the taxation policies with respect to representative offices (ROs) in China. The circular, which applies retroactively as from 1 January 2010 and abolishes previous guidance governing ROs, sets out the requirements relating to the methods to be used to calculate tax, the tax filing procedures, etc. applicable to ROs.

Setting up an RO in China is simple and convenient: there is no registered capital requirement, the application process is easy and the operating costs are relatively low. Therefore, registering an RO in China is generally the initial step for foreign companies wishing to invest in and experience the local market. Although the Chinese government has stipulated various restrictions on the activities of ROs (e.g. it has prohibited most ROs from carrying on direct business activities), in practice some ROs have conducted business beyond their approved scope. To address this issue, the State Administration for Industry & Commerce (SAIC) issued a "Notice on Further Strengthening the Registration Administration of Foreign Enterprises' Representative Offices" in January 2010, which imposes more stringent requirements on ROs (e.g. an RO is normally not allowed to have more than four representatives (including the Chief Representative)). These instances of non-compliance have also attracted the attention of the Chinese tax authorities; the SAT's issuance of Circular 18 follows from the recent rules issues by the SAIC.

As noted above, Circular 18 abolishes the other tax circulars on ROs, namely, Guoshuifa [1996] No. 165, "Notice on Relevant Issues Concerning the Strengthening of the Tax Collection and Administration of Representative Offices of Foreign Enterprises"; Guoshuifa [2003] No. 28, "Notice on the Tax Collection and Administration of Representative Offices of Foreign Enterprises"; and Guoshuifan [2008] No. 945, "Notice on Relevant Issues Concerning the Examination and Approval Procedures for a Tax Exemption for Representative Offices Established by Foreign Countries' Governments and Other Organizations."

Highlights of Circular 18

As a result of Circular 18, the methods of filing an Enterprise Income Tax (EIT) return and an application for an exemption from EIT are no longer determined based on the principal business of the head office of an RO. The new EIT treatments are as follows:

- EIT returns should be submitted and tax paid based on the profits attributable to an RO. Business Tax (BT) and Value Added Tax (VAT) returns should be submitted and tax paid in accordance with the relevant tax regulations.
- An RO is required to maintain accounting books and records based on official and valid vouchers. It also must accurately calculate its taxable turnover and profits ("actual amount method") based on a principle that reflects the actual functions performed by the RO and the risks borne. An RO should submit quarterly EIT and BT returns based on actual results within 15 days after the end of each quarter, and submit a VAT return and pay VAT due in accordance with the deadlines stipulated in the "Provisional Regulations of Value Added Tax" and implementation rules.
- If an RO is unable to provide a complete accounting record or if it cannot calculate its income and expenses with reasonable certainty, the tax authorities reserve the right to use one of the following "deemed amount methods" to determine taxable turnover and profits:
 1. A cost-plus method for an RO that is able to provide accurate details of its operating expenses but cannot accurately substantiate its turnover or costs; and
 2. The deemed profit method (based on the turnover) for an RO that is able to provide accurate turnover information but the cost and expense details are not clearly shown.
- An RO that is taxed according to one of the deemed amount methods may apply to the tax authorities to use the actual amount method if the RO can demonstrate that it can now maintain sound accounting books and records to calculate accurate taxable turnover and profits.
- Where the deemed amount methods are applicable, the deemed profit rate is increased from 10% to no less than 15%. The following example illustrates that the total EIT and BT burden will be increased by at least 24% for an RO taxed according to the cost-plus method.

		Old rules	New rules
Total operating expenses	A	100	100
BT rate	B	5%	5%
Deemed profit rate (the minimum deemed profit rate per Circular 18)	C	10%	15%
Deemed turnover	$D=A/(1-B-C)$	117.65	125
BT payable	$E=D*B$	5.88	6.25
EIT payable (tax rate at 25%)	$F=D*C*25\%$	2.94	4.69
Total tax burden (based on the expenses)	$G=100%*(E+F)/A$	8.82%	10.94%
% increase in total tax costs		$100\% \times (10.94 - 8.82)/8.82 = 24\%$	

- If the cost-plus method is used, the expenses required to be included in the cost-plus computation as required by Circular 18 remain almost the same as those under the old rules. However, Circular 18 provides that expenditure incurred on fixed asset additions and leasehold improvements will be treated as one-time expenses – an RO cannot use depreciation or amortization charges for purposes of the cost-plus computation.
- Circular 18 requires that the local tax authorities no longer accept applications for an exemption from EIT under the old rules, and should review and revisit the taxability of those ROs that were previously approved for the tax exemption. ROs that believe they are eligible for an exemption from EIT pursuant to a relevant tax treaty (or tax arrangement) may apply to the tax authorities for the exemption in accordance with the "Administration Measures on the Application for Preferential Treatment under a Tax Treaty by Nonresidents" (Guoshuifa [2009] No. 124).

Potential problems arising under Circular 18

- Circular 18 states that an RO engaged in activities subject to VAT must file a VAT return. However, since ROs usually do not have the capacity to carry on trading activities directly (e.g. there are restrictions on the import of merchandise, the issuance of invoices, the receipt of business proceeds, etc.), the reference to taxable activities subject to VAT should be clarified.

- The old regulations stipulated that ROs that only carried out market research, the provision of market information, and liaison and other preparatory and auxiliary activities in China for purposes of the manufacturing or sale of the products of their head offices were not to be subject to EIT or BT. Such ROs were eligible to apply for an exemption from both taxes. In contrast, Circular 18 only allows an RO to apply for an EIT exemption if there is a relevant tax treaty/arrangement. Practically speaking, it is a formidable challenge to prove to the satisfaction of the tax authorities that the activities carried out by an RO are only "preparatory and auxiliary" in accordance with a tax treaty/arrangement. Circular 18 also mandates that the local tax authorities refrain from accepting EIT exemption applications, but does not mention the BT exemption application. Even if an RO is able to obtain an exemption from EIT, it is unclear whether an exemption from BT is also available.
- For an RO with a simple function and low risk, the old deemed profit rate of 10% is normally not considered low in most cases. However, Circular 18 now prescribes the use of a deemed profit rate of no less than 15%. It is unclear whether the local tax authorities would use a higher deemed profit rate. On 20 February 2010, the SAT also issued "Administrative Measures for the Assessment and Collection of Enterprise Income Tax on Non-resident Enterprises" (Guoshuifa [2010] No.19, Circular 19), which provide that the deemed profit rate for non-resident enterprises should range from 15% to 50% (and maybe even higher in certain cases), depending on the nature of the services provided. It is unclear whether the local tax authorities would refer to Circular 19 to determine the appropriate deemed profit rate for an RO based on the principal business of its overseas head company. It is also unclear whether the local tax authorities would consider other factors in determining the deemed profit rate.
- Where an RO is taxed under the actual amount method, Circular 18 for the first time indicates that the RO should record its taxable turnover and profits according to the actual functions undertaken and risks assumed. From an economic perspective, this seems to imply that the SAT is focusing its attention on whether the amount of turnover and profits booked by the RO reflect a reasonable amount as compared to the results of the head office. Many issues obviously need to be clarified for the new rules to be able to be implemented.

Summary

The purpose of Circular 18 is to strengthen the collection and administration of taxes on ROs. The Circular abolishes the old approval procedures for a tax exemption application, requires a revisit of ROs that were tax exempt and increases the deemed profit rate. To some extent, these new measures may discourage foreign companies from setting up ROs in China. With the previous deemed profit rate of 10% already considered high by some ROs, the new deemed profit rate of 15% will undoubtedly increase the tax burden on ROs. Foreign investors should, therefore, examine whether their ROs qualify for a tax exemption under the new regulations. ROs that believe they are entitled to an exemption should apply for approval as soon as possible. Where an RO does not meet the new requirements for exemption, converting the RO to a wholly foreign-owned company may be an alternative. Furthermore, Circular 18 allows the local tax authorities of all provinces to set out specific operational procedures, so investors still need to pay close attention to the local tax authorities' policy developments and prepare to take action to mitigate potential risk.

The Deloitte professional services team will closely monitor and provide updates on new developments in this area and would be happy to provide you with further analysis of the tax implications of the new rules. If you need technical support or further information regarding the tax impact of the circular on ROs, please feel free to contact our tax professionals.

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