

# China Tax Update

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CLIENT ALERT

## China Issues New Rules on the Taxation of Representative Offices of Foreign Enterprises

The State Administration of Taxation (“SAT”) issued Guo Shui Fa [2010] No. 18 (“Circular 18”) - **Interim Measures on Tax Administration of Representative Offices of Foreign Enterprises** - on 20 February 2010. Circular 18 contains new rules on the taxation of representative offices of foreign enterprises (“Rep Offices”), invalidates a number of circulars<sup>1</sup> and has retrospective effect to 1 January 2010.

### General Introduction to the New Rules

Circular 18 defines a Rep Office as:

A permanent representative organization of a foreign (or Hong Kong, Macao and Taiwan) enterprise or other institution, which is registered with relevant administration authority of industry and commerce or approved by relevant authorities.

### Applicable Taxes

Circular 18 requires a Rep Office to declare and pay enterprise income tax (“EIT”) on income attributed to it, and business tax (“BT”) and value-added tax (“VAT”) on taxable turnover.

A Rep Office must establish accounting books and perform accounting based on legal and valid documents. Circular 18 also introduces the principle that a Rep Office must accurately calculate taxable turnover and taxable income according to its actual functions and the risks it assumes. It has a duty to declare and pay EIT and BT within 15 days after each quarter ends and to declare and pay VAT according to VAT regulations.

### EIT Payable Calculation

As abovementioned, Circular 18 sets up a principle that all Rep Offices must

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<sup>1</sup> Guo Shui Fa [1996] No. 165, Guo Shui Fa [2003] No. 28, Guo Shui Han [2008] No. 945

accurately calculate their taxes based on legal and valid accounting documents (“**Actual Calculation Method**”). However, if a Rep Office lacks complete accounting books and cannot accurately calculate income, costs or expenses, China’s tax authorities may choose either of the following methods to determine EIT payable on a deemed basis:

- **Expense Conversion Method:** this method applies to Rep Offices who can accurately calculate expenses, but not income or costs.

$$\text{Taxable Income} = \frac{\text{Expenses for the current period}}{\left[ 1 - \text{Deemed profit rate} - \text{BT rate} \right]}$$

$$\text{EIT Payable} = \text{Taxable income} \times \text{Deemed profit rate} \times \text{EIT rate (25\%)}$$

In this method expenses include salary, bonus, allowance and welfare fees paid to employees inside and outside China, facilities purchase fees (including fixed assets such as vehicles and office facilities), communication fees, travelling fees, housing rentals, equipment rentals, transportation fees, entertainment fees, etc.

Circular 18 also draws together certain rules in several circulars issued in the 1980s and 1990s<sup>2</sup> covering interest expenses, entertainment fees, donations, late fees/penalties, reimbursed charges, and other expenses. These rules are left unchanged. However, it does change the rule that applies to fixed asset purchase expenses and decoration expenses, as set out below:

When a Rep Office uses the Expense Conversion Method to calculate EIT, all fixed asset purchase expenses and decoration expenses - whether for set up or relocation - should be recognized as expenses at one time. But pursuant to Circular Guo Shui Fa [1998] No. 63, the tax authority in certain circumstances may allow the Rep Office to recognize fixed asset purchase expenses evenly over a period that equals the depreciation period of similar assets, and decoration expenses to be recognized evenly over 5 years.<sup>3</sup>

- **Deemed Profit Method:** this method applies to Rep Offices that can accurately calculate income but not costs or expenses.

$$\text{EIT Payable} = \text{Actual income} \times \text{Deemed profit rate} \times \text{EIT rate (25\%)}$$



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<sup>2</sup> E.g. [1988]Guo Shui Wai Zi No. 333, [1988]Guo Shui Wai Zi No. 338, [1989]Guo Shui Wai Zi No. 140, Guo Shui Han Fa [1991] No. 726, Guo Shui Han Fa [1991] No. 1303.

<sup>3</sup> It seems that Guo Shui Fa [1998] No. 63 has become invalid since 1 January 2010, the effective date of Circular 18.

Circular 18 stipulates that the deemed profit of a Rep Office is not lower than 15%. Previously, however, Rep Offices normally were subject to a deemed profit rate of 10%.

If a Rep Office which is taxed on the Expense Conversion Method or Deemed Profit Method can establish complete accounting books and accurately calculate the taxable turnover and taxable income, it may make a filing with its tax authority to start to pay tax according to the Actual Calculation Method.

#### BT and VAT Payable Calculation

If a Rep Office has conducted BT or VAT payable activities, it should calculate BT or VAT payable according to relevant laws and regulations. It seems that Circular 18 has stopped a Rep Office from using a deemed profit rate (10%) and a standard BT rate (5%) in calculating BT payables, which were allowed in the previous rules.<sup>4</sup>

#### Enjoying Tax Treaty Benefits

If a Rep Office seeks preferential treatment under an applicable tax treaty, it must undertake the procedures required by the tax treaty and **(Trying) Measures on the Administration of Enjoying Tax Treaty Benefits by Non-Residents** (Guo Shui Fa [2009] No. 124) (“Circular 124”).<sup>5</sup>

#### No EIT Exemption

Circular 18 states that local tax authorities must no longer accept any application for EIT exemption from Rep Offices. The local tax authorities must, based on the provisions of Circular 18, start to clean-up existing Rep Offices who have been enjoying tax exemption.

### Salans Comments

For historical reasons, SAT has conducted several significant changes on the taxation of Rep Offices since 1980s. During this process, SAT also issued many circulars to deal with complex tax issues arising from time to time. In practice, this has caused confusion to many tax payers and inconsistency among local tax authorities when following the rules. The inconsistency also theoretically exists between the tax rules and other rules issued by the Chinese government. According to **Administration Rules on Permanent Representative Offices of Foreign Enterprises** (“SAIC Rules”) issued by the State Administration of Industry and Commerce

<sup>4</sup> E.g. (85) Cai Shui Wai Zi No. 200

<sup>5</sup> According to Circular 124, a non resident must apply for Chinese tax authority's approval if it requests to enjoy tax treaty benefits on 1) dividends, 2) interests, 3) royalties or 4) capital gains; while for enjoying tax treaty benefits on other items such as 1) permanent establishment and business profits, 2) independent personal services, or 3) dependent personal services only a

("SAIC") in 1983, a Rep office cannot directly engage in business operations. This may create a theoretical challenge if tax authorities are entitled to tax the income of a Rep Office from business operations, while such income may be illegal under SAIC Rules.

China has already realized that this situation is vulnerable to tax cheating and other illegal practices, as can be seen from the following recent efforts:

- In August 2008, SAIC released a draft of new regulations on the administration of Rep Offices to replace the SAIC Rules. (Note that under this draft, Rep Offices are prohibited from engaging in "profit making activities", unless otherwise stipulated by an international agreement or treaty that China signs or participates in.)
- From 2009, SAT issued a series of circulars to strengthen the tax administration of non-residents, including SAT's decree No. 19, Circular124;
- On 4 January 2010, SAIC and the Ministry of Public Security jointly issued a circular on **Further Strengthening the Administration of the Permanent Representative Offices of Foreign Companies.**<sup>6</sup> (Note that under this circular SAIC will adopt certain measures against the Rep Offices, including attacking illegal business operations.)

The issuance of Circular 18 is undoubtedly another important signal that the government is strengthening the administration of Rep Offices, though there are still a number of ambiguities that need to be clarified, either by further interpretation by tax authorities or by the issuance of corresponding rules by other Chinese government authorities, e.g. SAIC.

Currently the major ambiguities include:

- Circular 18 clearly states that local tax authorities may no longer accept a Rep Office's tax exemption application.
  - ◆ Does that mean no new Rep. Office applied with the tax authorities after 1 January 2010 may enjoy EIT exemption?
  - ◆ What if a Rep Office actually conducts preparatory, auxiliary, or other activities for the non-resident enterprise it belongs to, and such activities do not cause the Rep Office to be deemed as permanent establishment under an applicable tax treaty?
  - ◆ Can the Rep Office then enjoy EIT exemption by making a filing with its tax authority according to Circular 124?
- While setting up a general requirement to pay tax based on Actual Calculation Method, Circular 18 enhances the deemed profit rate from

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filing with the tax authority is required.

<sup>6</sup> Gong Shang Wai Qi Zi [2010] No. 4

10% to at least 15% if a Rep Office uses either of the other two methods. However Circular 18 does not specify the deemed profit rate for Rep Offices in different industries. Would tax authorities apply on Rep Offices the deemed tax rates stipulated in Administration Rules on the Deemed Income Tax of Non-residents (Circular (Guo Shui Fa [2010] No. 19) (“Circular 19”)<sup>7</sup> as set out in the table below?

<b>Non-residents under Circular 19</b>	
<b>Taxable Actives</b>	<b>Deemed Profit Rates</b>
Project contracting, design and consulting services	15%-30%
management services	30% to 50%
Other services or other business activities other than services	At least 15%

It seems that enforcing Circular 18 will be one of SAT's focuses in 2010.<sup>8</sup> We recommend that our Rep Office clients - particularly those that have enjoyed tax exemption treatment – be aware of the terms of Circular 18 and prepare for possible inspection by the tax authorities. Currently, initial tax optimizing measures (including transforming legal forms and clearing unnecessary functions) can be considered.

Moreover, if a foreign enterprise considers that the taxation of its Rep. Office does not accord with the tax treaty between China and its home country, it may invoke the conciliation procedure between governments under the tax treaty. By this procedure, the foreign enterprise may present its case to the competent authority of its home country within 3 years from the date on which the suspect taxation was first notified to it. We expect that the ambiguities and uncertainties will be clarified by the development of China's legal and tax system governing Rep Offices. We will keep a close watch on related legal and tax practices in this regard.

<sup>7</sup> This circular was issued by SAT on the same date issuing Circular 18.

<sup>8</sup> Source: [www.ctaxnews.com.cn/syxw/xwxzt/201002/t20100212\\_1556951.htm](http://www.ctaxnews.com.cn/syxw/xwxzt/201002/t20100212_1556951.htm)

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