

News Flash

China Tax and Business Advisory

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With over 1,200 China tax professionals and 50 China tax partners in 12 cities in Mainland China, Hong Kong, and Singapore, our PwC China Tax and Business Service Team provides a full range of tax advisory and compliance services. Leveraging on a strong international network, our tax specialists are striving to offer technically robust, industry specific, pragmatic and seamless solutions to our clients on their tax and business issues locally. The Global Tax Monitor recognises PwC as having the strongest overall reputation for tax services in China, with a lead over the competition.

New Landscape of Taxation Rules for Representative Offices of Foreign Enterprises in China

Representative Office (“RO”) has been a popular form of business adopted by foreign investors to get into the Chinese markets for its simple registration process, no capital lock-up requirement, less stringent business regulatory requirements, relatively low tax costs and non-complex tax compliance, straightforward exit procedures, etc. During the past two decades, the taxation of ROs was governed by various tax rules under the former Foreign Enterprise Income Tax (“FEIT”) regime. Since the new Corporate Income Tax (“CIT”) Law became effective on 1 January 2008, the China’s State Administration of Taxation (“SAT”) has not issued any tax rules relating to the taxation of ROs under the new CIT regime. In that respect, both ROs and local-level tax bureaus have been following those former FEIT tax rules in reporting and administering the taxation of ROs respectively and, in practice, the taxation of ROs has so far remained unchanged other than that the tax rate is reduced from 33% to 25% (or even lower for some locations).

On 20 February 2010 the SAT released the “Provisional Measures for Tax Collection and Administration of Representative Offices of Foreign Enterprises” (“the Measures”) on the tax rules relating to the taxation of ROs under the new CIT regime (Circular Guoshuifa [2010] No.18). The Measures are significantly different than the previous tax rules and made effective retrospectively from 1 January 2010.

In this issue of News Flash, we will highlight the salient points of the Measures and share our observations in relation to the new rules on RO taxation.

Salient Points of the Measures

- **Scope of ROs:** The ROs covered in the Measures refer to those representative offices established in China by foreign enterprises (including enterprises in Hong Kong, Macao and Taiwan) and other organizations. Virtually, it covers almost all ROs.
- **Tax registration / de-registration:** ROs need to perform tax registration within 30 days after the relevant business registration / approval is obtained. Detailed documentation requirements for tax registration are provided in the Measures. Amendment / Tax de-registration are required when the contents of the tax registration have changed or the RO ceased operations. ROs are required to report CIT on their liquidation income before tax de-registration.

- **Tax liabilities and filing requirements:** Taxable income of RO is subject to CIT. Where RO carries on activities which are subject to Business Tax ("BT") or Value Added Tax ("VAT"), the relevant taxes shall be calculated and filed in accordance with the BT or VAT regulations. ROs are required to report CIT and BT on a quarterly basis; while the reporting of VAT should follow the relevant tax filing periods in the VAT regulations.
- **Taxation methods:** Generally, ROs are required to keep proper accounting records to ascertain the actual revenue / profit and file tax on the same. The Chinese tax authorities shall adopt "deeming method" for ROs which cannot accurately ascertain its revenue and costs, or calculate and file their tax liabilities on an actual basis. These "deeming methods" include "Expense-plus method" (also known as "Cost-plus Method") and "Actual Revenue Deemed Profit Method". The detailed rules on determination of the expenses under the Expense-plus Method are generally in line with those under the former FEIT regime, with minor changes. The following table illustrates the applicability and CIT treatment under the three different taxation methods for ROs.

Taxation Method		Relevant Treatment
Actual basis		<ul style="list-style-type: none"> • <u>Applicability</u> Generally, ROs shall file tax on an actual basis, based on their books and records, and the reported profit should commensurate with functions and risks undertaken by the RO. • <u>Tax treatment</u> CIT = Actual taxable profit x CIT rate BT / VAT = Actual taxable revenue x applicable BT/VAT rate^{Note1}
Deeming methods	Expense-plus Method	<ul style="list-style-type: none"> • <u>Applicability</u> For ROs who are able to accurately ascertain expenses but not revenue or cost • <u>Tax treatment</u> Deemed gross revenue = expenses for the period / (1 – deemed profit rate - applicable BT rate) CIT = Deemed gross revenue x deemed profit rate^{Note 2} x CIT rate BT = Deemed gross revenue x applicable BT rate^{Note 1}
	Actual Revenue Deemed Profit Method	<ul style="list-style-type: none"> • <u>Applicability</u> For ROs who are able to accurately ascertain revenue but not cost or expense • <u>Tax treatment</u> CIT = Actual gross revenue x deemed profit rate^{Note 2} x CIT rate BT/VAT = Taxable revenue x applicable BT/VAT rate^{Note 1}

Note:

1. The Measures stipulate that the calculation of BT/VAT should be in line with their respective regulations.
2. The Measures stipulate that the deemed profit rate cannot be less than 15%.

In addition, an RO which files tax under the "deeming method" may, after record-filing with the in-charge tax authority, switch to the "actual basis" provided that it can maintain complete accounting books, ascertain its taxable revenue and profit and calculate tax liabilities accurately.

- **Tax exemption:** The Measures have invalidated the previous tax circulars¹ governing various taxation treatments for ROs under FEIT regime starting from 1 January 2010. Specifically, there should be no more tax exemption for ROs and the local-level tax bureaus are required to clean up the previously approved exemptions. However, ROs may still be able to enjoy treaty treatments (essentially "treaty protection"), but they have to

¹ Guoshuifa [1996] No.165, Guoshuifa [2003] No.28 and Guoshuihan [2008] No.945

undergo the relevant administrative procedures set out in the SAT Circular Guoshuifa [2009] No.124 (“Circular 124”²), which addresses the procedures for claiming treaty benefits by non-residents.

PwC Observations

As noted above, the Measures are significantly different than the previous tax rules under the former FEIT regime. We set out below our observations of the critical changes:

Rationale and motivation of the changes

- RO taxation in China has been an interesting topic for more than a decade. On one hand, ROs of foreign enterprises are not allowed to carry on income-generating business as restricted by the Chinese business registration regulations and can only carry out coordination and liaison activities for their overseas head offices or affiliates. However, on the other hand, the Chinese tax authorities have been taking a view that ROs in China are contributing values to the generation of income for the overseas head offices. Therefore, ROs should pay taxes in China. Nevertheless, it has been a difficult technical issue as to how to determine the values (income and profits) attributable to the ROs in China, because the ROs usually argued that they were only allowed to conduct coordination and liaison activities in China and no income was generated. As a compromise, in most cases under the former FEIT regime, ROs were allowed to report their tax on the deeming methods, in particular the Expense-plus Method. There were some cases where ROs were required to report tax on actual basis, e.g. foreign law firms’ ROs in China.
- However, the SAT has realized that some ROs have a very large number of staff or a single foreign enterprise has many ROs across China. The SAT has formed the view that these ROs are set up for the objective of carrying on profitable business activities in China, and the adoption of the deeming methods, in particular the Expense-plus Method, just presents a tax loophole for foreign enterprises to use ROs, and creates inequity when comparing to those incorporated companies in China who are subject to tax on an actual basis.

Change of tax filing basis

- Now, the Measures have put the emphasis on “actual basis” for tax filing of ROs. It appears that the SAT has a presumption that ROs are set up for the objective of carrying on taxable activities in China and should have kept accounting books and records to determine the actual revenue and profits for their own business purposes. Consequently they should be able to report tax on an actual basis. Only when the in-charge tax bureau examines and agrees that an RO has failed to keep complete/accurate books or is unable to calculate and file their tax liabilities on an actual basis, would the RO be allowed to file on the deemed basis, and the in-charge tax bureau would choose the deeming method to be used. In other words, ROs are not allowed to choose to adopt the deeming methods.
- In addition, the Measures now require the ROs to ascertain its revenue and profits using the principle of returns commensurate with the functions and risks. Such a change sounds a good move towards the OECD guidelines and widely-accepted international tax practice for determining the attributable profits of the permanent establishment of non-residents in another jurisdiction. However, putting this in China context, it could translate into difficulties and challenges to both ROs and the Chinese local-level tax bureaus in terms of compliance burden and technical controversy.
- As the existing tax filing basis for ROs has been adopted for over a decade and the Expense-plus Method was generally the preferred method of the local-level tax bureaus, it still needs to wait and see whether they would stick to the previous tax rules.
- Furthermore, although it is not clear whether the existing filing basis of ROs would be re-examined or not, it would be highly recommended for those ROs which are using the “actual revenue deemed profit ” method and performing “nil-tax” filings to review their current status to ensure that the “zero” revenue claim is supportable.

² Please refer to our China Tax and Business News Flash Issue [2009] No.20 for details.

Raising the deemed profit rate

- The deeming methods, in particular the Expense-plus Method, were widely adopted as tax filing method for existing ROs. They will be facing a heavier tax burden with the deemed profit rate being raised from 10% to a minimum of 15%. The change could be to some extent brought about by the reduced CIT rate (from 33% to 25% in most locations), and also to serve as a deterrent to ROs in continuing the deeming methods and push them to report their actual revenue and profits. Please note that the new deemed profit rate of 15% is not simply a fixed rate now, but rather set as a minimum. It implies that there could be discretion for the local-level tax bureaus to adopt a profit rate of even higher than 15%, if they think fit. It is still not clear what basis the local-level tax bureaus would use to set a higher rate.

Cancellation of tax exemption for ROs

- Another eye-catching change is the cancellation of tax exemption for ROs across the board. In addition to the belief that ROs are mostly carrying on income-generating activities, the SAT has also realized that there is no legal basis under the CIT tax regime to grant tax exemption to ROs. Technically, ROs may only achieve no-CIT status by invoking treaty protection under the relevant double tax agreement (“DTA”). If the RO only carries on exempted activities (which are generally listed in the “Permanent Establishment (“PE”) Article of the DTA, namely providing auxiliary and preparatory activities for its overseas head office), then the foreign enterprise which sets up the RO would not be considered to have a PE in China and should not be subject to CIT in respect of the activities of the RO.
- The Measures require the ROs to follow the relevant procedures under Circular 124 in claiming treaty benefits. It is worth noting that, under Circular 124, treaty protection is only subject to record-filing procedures instead of approval-application procedures. However, it is unlikely that, in practice, a RO could automatically enjoy treaty protection upon the required documents are filed for record. Rather, the documents would likely have to be verified by the local-level tax bureaus before the treaty protection is validated.
- Actually, obtaining tax exemption for ROs from the Chinese tax authorities has never been easy. The impact of cancellation of tax exemption might not affect many ROs. Rather, the change to securing treaty protection under the relevant DTA may present a better chance for some ROs to achieve no-CIT status.
- The Measures state clearly that all previously approved tax exemption cases should be invalidated in accordance with the rules prescribed in the Measures. Therefore, ROs which are currently enjoying tax exemption should review the current activities / operations and assess their qualification of no-CIT status by virtue of treaty protection under the relevant DTAs.
- Tax exemption for ROs set up by foreign government, international organizations, non-profit organizations and other civil groups is not specifically addressed in the Measures. It is believed that these special ROs would also need to rely on the relevant treaty protection to enjoy no-CIT status.
- Since DTAs only cover CIT and not turnover taxes, such as BT and VAT, ROs which have treaty protection (for CIT) under DTAs may still be liable to BT/VAT for their BT-able/VAT-able activities. Such situation could also cause complicated tax filing issues.

Turnover tax

- It has been a consistent tax view and practice that BT should be applicable to ROs as they are more or less involved in providing services, namely coordination and liaison activities. The Measures now have stipulated that ROs may also be subject to VAT, which is generally applicable to the sale of tangible goods. It may imply that the Chinese tax authorities are ready to challenge that some ROs are carrying on the business of trading in tangible goods within China and hence should be subject to VAT. However, the Measures do not provide too much clarity at this stage.

Timing

- With the effective date of the Measures being retrospective to 1 January 2010, the first filing period under the Measures would be the first quarter of 2010 and the filing is due on the coming mid-April. Both ROs and local-level tax bureaus may not be well prepared for the changes brought about by the Measures within such a short timeframe. On the other hand, the Measures allow the provincial-level tax bureaus (or equivalent) to formulate their own implementation procedures within the scope of the Measures. Due to the short timeframe, some provincial-level tax bureaus (or equivalent) may not be able to adopt the Measures for the 2010 first quarter filing before finishing their implementation set-up. ROs should stay tune for the development and requirements in their localities.

Conclusions

No doubt, the new Measures has shaped a new landscape for the taxation of most ROs of foreign enterprises in China. It will inevitably have significant impact to ROs in China.

Firstly, this puts the ROs in a very difficult position from the tax and legal (regulatory) angle. It is a dilemma that, on one hand, the Chinese business registration regulations only allow foreign enterprises to set up ROs in China for coordination and liaison activities, while on the other hand the Chinese taxation rules treat them as carrying on income-generating business and tax them accordingly.

Nevertheless, ROs should start preparing for tax development and new requirements in their localities. They should revisit their existing tax profile, review their functions and risks, get ready to maintain the accounting books and records which should accurately ascertain their revenue and profits, etc.

The change is very new, and communication is of utmost importance. ROs should inform their overseas head offices about the changes and solicit support to improve their accounting books and records. Where practically viable, the overseas head office may even carefully consider converting their form of business from RO to an incorporated company. At the same time, ROs may actively and timely communicate with their local-level tax bureaus to seek clarity on their tax treatments.

As the title of Circular 18 suggests, it is just a set of provisional tax measures. It implies that the SAT may issue further guidelines or clarification as and when necessary. We will keep monitoring the relevant development and share with any update in this respect.

In the context of this News Flash, China or the PRC refers to the People's Republic of China but excludes Hong Kong Special Administrative Region, Macao Special Administrative Region and Taiwan Region.

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