

Recent Tax Changes for Representative Offices in China

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1. Background

China opened her door to foreign investors since early 1980's and representative office ("RO") has always been a common form of establishment used by foreign investors to explore the China market for various reasons, such as, simple registration procedures, no capital requirement, relatively simpler exit process and etc.

As ROs are not allowed to conduct revenue generating activities in China, technically speaking, no income is derived in China and it seems logical to exempt ROs from paying taxes. As time goes by, the view changes, the Chinese tax authorities consider that some ROs do carry out activities in China from which any revenue earned may not appear in their accounting records but rather would benefit their overseas affiliated offices. Unless they are able to fulfill certain conditions ROs gradually become much difficult to claim for tax exemption.

Nevertheless, during the past 2 decades, the taxation of ROs in China remains relatively stable and pretty much follows the old Foreign Enterprise Income Tax ("FEIT") provisions. In general, the tax positions of ROs in China would fall into one of the following categories:

- (a) In most cases, ROs would be subject to Enterprise Income Tax ("EIT") and Business Tax ("BT") in China on cost-plus basis.
- (b) For ROs that conduct business activities (e.g. legal, accounting etc) in China, they are required to maintain proper accounting records and file EIT and BT on actual income basis.
- (c) Certain types of ROs (e.g. ROs established by foreign governments, non-profit organizations etc) could be exempt from taxes in China.

On 20 February 2010, the State Administration of Taxation ("SAT") issued the tax circular "Provisional Regulations for Tax Collection and Administration of Representative Offices established by Foreign Enterprises" [*GuoShuiFa (2010) No.18* – Circular 18] to address the taxation of ROs under the new EIT regime. When compared with the old tax rules relevant to ROs, Circular 18 introduces various changes and reshapes the tax regime applicable to ROs effective from 1 January 2010.

This Newsletter aims at providing you with highlights on Circular 18 and commenting on the implications.

2. Highlights and implications

Circular 18 contains the following changes:

2.1 Taxes applicable to ROs

ROs are usually subject to EIT and BT. Circular 18 indicates that ROs can also be subject to Value Added Tax (“VAT”).

Implications

BT is a type of turnover tax and is mostly applicable to ROs for the reasons that ROs are considered as engaged in the activities of provision of services (like co-ordination and liaison services).

Circular 18 now indicates that ROs can be subject to VAT. VAT is generally applicable to the sales of goods or provision of repair / processing / replacement services. These activities are supposed not to be carried out by ROs. The applicability of VAT implies that the Chinese tax authorities are of the view that some ROs are conducting VAT-able activities in China. However, Circular 18 has not provided any details how the VAT regulations will be applied to ROs, for instances, whether or not ROs can become general VAT payers or they can issue VAT invoices as if the other taxpayers chargeable to VAT. Detailed mechanism on the implementation is not covered in Circular 18 and hopefully the SAT will give further guidelines in the future.

2.2 Taxation methods

One of the major changes to ROs is the taxation method. Under the old rules, most of the ROs would be subject to EIT and BT on cost-plus basis whereby keeping records of the expenses incurred will be sufficient for tax filing purposes.

However, ROs are now expected to maintain proper accounting records and file taxes on actual basis. Their profits will be ascertained by reference to the functions and risks undertaken.

Tax authorities could adopt “deemed method” to tax the ROs when they are unable to maintain proper accounting records or unable to ascertain revenue or expenses reliably. Deemed method includes:

- (i) “Cost plus method” – applicable when the RO can reliably ascertain expenses but not revenue (this basis is now commonly adopted); and
- (ii) “Revenue deemed profit method” – applicable when the RO can reliably ascertain revenue but not expenses.

Implications

Circular 18 switches the principal taxation methods from “deemed basis” to “actual basis”. In another word, ROs will have to maintain proper accounting records and file their taxes on “actual basis”. Theoretically, they are no longer taxed under the “deemed basis”. However, in reality, this will be difficult for ROs to change to actual basis; in particular, for the cases that the ROs do not receive any income.

Circular 18 also requires ROs to ascertain their profits by reference to the functions and risks assumed. However, Circular 18 does not contain much further details, for instances, whether or not ROs have to follow the transfer pricing methodologies stated in *GuoShuiFa (2009) No.2* to ascertain its level of profits; or it has not specified the consequence for the non-compliance.

3. Deemed profit rate

Currently, under cost-plus method, an RO’s EIT and BT liabilities are calculated as follows:

$$\text{Deemed revenue} = \frac{\text{Operating expenses of the RO}}{1 - 10\% \text{ (deemed profit rate)} - 5\% \text{ (BT rate)}}$$

$$\text{BT} = \text{deemed revenue} \times 5\% \text{ (BT rate)}$$

$$\text{EIT} = \text{deemed revenue} \times 10\% \text{ (deemed profit rate)} \times 25\% \text{ (EIT rate)}$$

With effect from 1 January 2010, the deemed profit rate should become of not less than 15%. It means that the ROs will have to bear higher amount of tax liabilities.

Implications

The increase in deemed profit rate will impose heavier tax burden to ROs. The change of deemed profit rate from 10% to 15% will result in a higher EIT liability by around 59% and BT by around 6%.

One of the reasons for increasing the deemed profit rate could be to compensate the reduced EIT rate that was effected from 1 January 2008 (from 33% to 25%). It is also possible that the Chinese tax authorities attempt to force ROs to file tax returns on actual basis (so that they need to maintain proper accounting records).

The deemed profit rate is now set at a minimum at 15% but it does not imply the minimum rate is acceptable to the tax authorities. The introduction of a minimum level instead of a fixed deemed profit rate could expose ROs to potential higher tax liabilities although we understand that some tax authorities will adopt the minimum deemed profit rate of 15%.

At the moment, some ROs continue to file tax returns at the deemed profit rate of 10%. Tax authorities may make subsequent adjustments to these returns by adopting the minimum deemed profit rate of 15% with retroactive effect from 1 January 2010.

4. Cancellation of tax exemption for ROs

Circular 18 rules out the possibility of claiming tax exemption by ROs effective from 1 January 2010; the only exception is if they are entitled to eligible treaty benefits. Some ROs which have been previously granted with tax exemption will unlikely to continue to enjoy tax exemption. Tax authorities are expected to cancel any tax exemption previously granted.

Nevertheless, Circular 18 has not denied ROs to claim for eligible treaty benefits (e.g. the RO is only providing preparatory and auxiliary activities in China so it would not be regarded as a permanent establishment). These ROs will need to apply for such treaty benefits according to the procedures stipulated under *GuoShuiFa (2009) No.124* (“Circular 124”).

Implications

For ROs that are currently exempt from taxes will be subjected to review of their tax exemption status previously granted. If the tax exemption provisions under the relevant tax treaties do not apply, the ROs will likely be chargeable to taxes in China.

ROs qualify for treaty benefits will have to go through the recording-filing procedures set out in Circular 124. The following points can be of interest:

- (a) Under Circular 124, when applying for treaty benefits in respect of permanent establishment and business profits, it is only required to file a record for claiming tax exemption but no need to go through the approval procedures which are applicable to passive income like dividends, royalties etc. It is not known will further approval procedures be in place which will avoid future denial of tax exemption claimed by ROs by mistake.
- (b) Most double tax agreements only cover EIT exemption / relief and credit treatments but not turnover taxes like BT and VAT. As a result, under Circular 18, ROs may be entitled to EIT exemption under the relevant tax treaties but not BT or VAT.

5. Conclusion

Circular 18 introduces many changes to the current tax regulations governing ROs. How these changes would be executed and implemented are yet to be seen.

However, the tax filing on “actual basis” poses legal dilemma to ROs. In general, ROs are not allowed to conduct revenue generating activities in China. Circular 18 now requires ROs to ascertain their revenue by reference to their functions and risks, which seems to be contradictory to the capacity of ROs. There will be inconsistency in ascertaining the legal and tax position of ROs.

The change in tax filing basis and the increase in deemed profit rate will add tax cost to ROs in China. ROs should review if their modes of operation would affect the tax filing basis, for instances, cost-plus basis may no longer be acceptable by tax authorities. If “actual basis” is applicable, should a sound accounting system need to be in place to ensure proper tax filing will be performed.

It is also worthwhile for foreign investors to review their investment structures and future investment strategy in China. With the increase in the deemed profit rate, ROs may no longer be the most tax efficient form of investment in China; in addition, the legal and tax conflict may expose ROs to legal risks. Other investment structure, such as foreign invested enterprises can be an alternative option to consider.

You are advised to contact our colleagues in Hong Kong and / or China offices for further advice should the above have impact on your business.

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