

Tax administration on foreign companies deriving income through PRC establishments

The Chinese ("PRC") authorities play a positive role in monitoring the operations of foreign (non-PRC) companies conducted inside China, strengthening administration and requiring them to conduct business in compliance with the local relevant laws and regulations. For example a number of tax circulars have recently been issued by the PRC State Administration of Taxation ("SAT") strengthening tax administration of foreign companies deriving income through local establishments in China.

In February 2010 SAT issued Circulars Guoshuifa [2010] No.18 "Provisional Regulations on Tax Administration for Representative Offices of Foreign Enterprises" ("Circular 18") and Guoshuifa [2010] No.19 "The Administrative Measures for the Collection of Corporate Income Tax on Non PRC resident enterprises on a deemed basis" ("Circular 19") to clarify certain tax filing positions and administrative procedures applicable to non-resident enterprises in China.

In this article we have summarised the major measures covered by these circulars.

I. CIRCULAR 18

Circular 18 was issued to replace the existing tax rules applying to all PRC representative offices ("ROs") established by foreign enterprises. All foreign investors with ROs in China should refer to this circular for all tax administration, treatment and related matters effective 1 January 2010.

The major highlights are detailed below.

1. Determination of RO Taxable Income

The taxable profits of a RO may be determined by actual profits, deemed profits or expenditure gross-up method.

Actual profit basis

This method will apply to a RO which can provide all information and documentation relating to contracts, commission rates and so on, together with a full set of accounts which have been kept in the PRC covering payments, receipts, costs and expenses which are subject to annual audit by a PRC registered Certified Public Accountant ("CPA"). The expenses incurred overseas have to be supported by an auditors' report issued by a foreign CPA in the respective locations. ROs of foreign local firms fall within this category.

Deemed profit basis

This method is used when a RO can only provide the information and documentation for completed contracts. The net taxable income of the RO cannot be ascertained due to a lack

of information on commission amounts and/or accurate substantiation of costs and expenses incurred. Accordingly the tax bureau will apply a deemed profit rate to the contracts sum to derive the RO's taxable income.

It is noted unusual for the tax bureaus to accept a RO trying to report a deemed profit basis.

Expenditure gross-up basis

This method is used when a RO cannot provide sufficient information and/or documentation to the tax authorities to substantiate its gross income.

ROs are required to keep a full set of accounts in the PRC to report all the costs and expenses incurred. Such accounting records are subject to annual audit by a PRC registered CPA. The operating expenses so reported will be grossed-up to establish a gross income that covers the Business Tax ("BT") liability and the deemed profit for Enterprise Income Tax ("EIT") purposes. Pursuant to Circular 18 RO's deemed profit rate should not be less than 15% effective 1 January 2010:

$$\begin{aligned} \text{Gross Income} &= \frac{\text{Total expenses of the RO}}{[1 - (\text{BT rate}) - (\text{Deemed profit rate})]} \\ &= \frac{\text{Total expenses of the RO}}{[1 - 5\% - 15\%]} \\ &= 125\% \text{ of total expenses of the RO} \end{aligned}$$

Hence PRC BT and ET will be computed as follows:

$$\begin{aligned} \text{PRC BT} &= \text{Gross income} \times 5\% \text{ (BT rate)} \\ &= 125\% \text{ of total expenses of the RO} \times 5\% \\ \text{PRC EIT} &= \text{Gross income} \times 15\% \text{ (deemed profit rate)} \times 25\% \text{ (EIT rate)} \\ &= 125\% \text{ of total expenses of the RO} \times 15\% \times 25\% \end{aligned}$$

Effective Tax Rate (BT + ET) = approximately 10.94% (of Total Expenses)

Pursuant to Circular [2003] 28 expenditure gross-up basis should be applied to those ROs whose head offices engage in agency or trading services effective from 1 July 2003.

2. RO Tax Exemption

Circular 18 states that the PRC tax bureaus will no longer accept and consider applications submitted by ROs for tax exemption. Having that said, there is no written specification on whether the existing tax exempted ROs may continue to enjoy their tax free status.

II. CIRCULAR 19

The newly introduced Circular 19 is applicable to all non PRC resident companies that derive income that is either China sourced from their establishments in China or non-China-sourced income that is effectively connected with the establishments in China. Circular 19 be effective on 20 February 2010.

Below please find some of the major highlights on Circular 19 for reference purpose:

1. Determination of Taxable Income

The methodology of determination of taxable income for non-resident companies was re-visited. Methods include actual profit basis, deemed profit basis and expenditure gross-up basis.

Circular 19 specifies that, regardless of what type of methodology is adopted, taxable income should be computed with reference to the functions and risks undertaken by the PRC operations.

2. Increase of Deemed Profit Rates

Circular 19 provides the range of deemed profit rates to be applied under the "deemed profit methods" for different types of businesses. The new Circular has increased deemed profit rates from a generally adopted range of 10%–40% to 15%–50%. The new deemed profit rates are as follows:

- | | |
|---|-------------------|
| (a) Construction and engineering projects, design and consulting: | 15%–30% |
| (b) Management services: | 30%–50% |
| (c) Other services: | not less than 15% |

One key point to note is that, the local tax bureaus are allowed to determine the actual deemed rate within the prescribed ranges, and where tax bureaus consider that the actual rate should be higher than the deemed rate, the bureau can even adopt a deemed rate higher than the prescribed range set out in the circular.

This may be beneficial for a taxpayer to choose to be taxed on an actual basis versus the deemed profit method where the deemed profits rates are higher than actual. Proper, complete and accurate accounting records must be maintained to be able to be taxed on an actual basis.

3. Mixed Sales

A single sales transaction that involves both the provision of non-VAT taxable services and the sale of tangible goods is referred to as “mixed sales”. For example, a manufacturer may provide a service to install goods sold. Another example is where a construction company providing services may also supply the building materials. A “mixed sale” occurs only when the services would not be independently provided without the sales.

Under Circular 19 when there is a contract which involves both the provision of goods and services at the same time, the PRC tax bureau may assess the service income by reference to pricing standards in the same or similar service sector in cases when the service fee portion is not explicitly specified in the contract, or not charged on a deemed reasonable basis. In cases

where no appropriate reference is available, the service proportion shall not be less than 10% of total contract sum.

4. Offshore and Onshore Services

Prior to the introduction of Circular 19 services rendered by non residents were only taxed on the China sourced portion. Offshore services were not subject to EIT in China. Circular 19 now clarifies that when there is doubt as to the reasonableness of the onshore and offshore service income allocation, the PRC tax bureau can seek supporting evidence. If the supporting evidence is not considered to be sufficient, the tax bureau may either determine an appropriate split using factors such as time, cost and location. The tax bureau may even determine that 100% of the services are deemed to have been performed within China.

III. OUR COMMENTS

General Overview

An overview of SAT's recent tax circulars addressing the tax positions and administrative procedures applicable to non-resident enterprises in China apparently illustrates that SAT is gearing up its efforts to tighten the tax administration on foreign companies. Even though there are still some outstanding issues that require further clarification on the actual implementation of the circulars (e.g. Circular 19 does not address the transitional tax position for those on-going service projects started prior to but not yet completed by 20 February 2010), foreign enterprises should start to conduct in-house reviews on the existing arrangements and plan for the future. Suggestions include, but are not limited to:

- Conduct a detailed analysis on the existing and future tax exposure associated with activities in China;
- Determine the best methodology to be adopted for derivation of taxable income in China;
- Review all relevant existing contracts and agreements to ensure appropriate content in relations to fee calculation basis, mixed sales and onshore/offshore separation are included;
- Ensure sufficient and appropriate supporting documentation are readily available in the case of potential challenges raised by the PRC tax bureau; and
- Determine if it is necessary to clarify and discuss with the local level tax authorities on any areas of perceived uncertainty in relation to the interpretation and implementation of these circulars.

Permanent Establishment

According to most double tax agreements signed by the PRC government, the PRC tax authorities may impose tax (on profits attributable to permanent establishments) on a foreign enterprise if that enterprise is held to have a permanent establishment ("PE") in the PRC. From a tax perspective a PE generally will have the following features:

- It must be a place of business whether owned or rented by the enterprise.
- It must be a fixed place of business with a certain degree of permanence.
- The enterprise must carry on the whole or a part of its business through this fixed place of business.

PE includes building sites, constructions, assembly or installation projects or supervisory activities in connection therewith, and the sites, projects or activities should last for more than 6 months. The period for which a project is carried out is counted from the date the contractor commences work (including any preparatory activities) up until the date on which the work is totally completed and handed over to the user. In cases where two or more sub-projects are contracted for by a person at the same site or for the same project, the period is counted from the date of commencement of the first sub-project to the date of completion of the last sub-project of that person.

PE also includes the furnishing of services (including consultancy services) by an enterprise directly or through employees or other personnel engaged by the enterprise, with services continuing (for the same or a connected project) for a period or periods aggregating more than 6 months within any 12-month period.

The importance of the PE concept as described above is that Circular 19 is applicable only to foreign enterprises that have established a PE in China. In cases where your China activities do not constitute PE exposure, neither Circular 18 nor 19 are relevant.

Establishment Entities in PRC

In addition to the above, companies may consider setting up a PRC wholly foreign owned enterprise (“WFOE”) to perform the “onshore” services in China.

Foreign investors can set up representative offices, branches (for financial institutions only) and subsidiaries (usually in form of foreign investment enterprises) in China. Besides manufacturing activities, foreign investment enterprises can engage in most service industries in addition to commercial activities, such as commission agency, wholesaling and retailing of merchandise, and franchising.

A comparison of two most common forms of establishment, wholly foreign owned enterprise (“WFOE”) and RO is detailed as follows:

	WFOE	RO
Pros	<ul style="list-style-type: none"> ▪ Foreign investor has full equity control and management control ▪ Can conduct trade and business in China ▪ Can hire local Chinese employees 	<ul style="list-style-type: none"> ▪ Quickest way to set up ▪ Lower risk with initial market testing
Cons	<ul style="list-style-type: none"> ▪ Cannot set up WFOE in some specific restricted industries (which need to be in the form of joint venture) ▪ Higher set up costs 	<ul style="list-style-type: none"> ▪ Cannot engage in direct business activities or enter into contracts ▪ Must engage local agent to hire local Chinese employees
Registered Capital	<ul style="list-style-type: none"> ▪ Depends on the scale of operations and generally cannot be reduced during the term of the WFOE 	<ul style="list-style-type: none"> ▪ Not applicable
Governance	<ul style="list-style-type: none"> ▪ Board of Directors ▪ Chairman of the Board is considered as the legal representative 	<ul style="list-style-type: none"> ▪ Chief Representative
Tax	<ul style="list-style-type: none"> ▪ Subject to PRC corporate taxation ▪ May enjoy tax preferential treatment under Double Tax Treaty 	<ul style="list-style-type: none"> ▪ Taxation on expenses on a deemed income basis, mainly enterprise income tax, business tax and individual income tax
Reporting and Compliance	<ul style="list-style-type: none"> ▪ Monthly Reports, Quarterly Reports, Annual Audit and Annual Inspection 	<ul style="list-style-type: none"> ▪ Monthly Reports, Quarterly Reports and Annual Audit
Time for Set-up	<ul style="list-style-type: none"> ▪ 2-4 months 	<ul style="list-style-type: none"> ▪ 1-2 months

For comparison purposes, we detail below a sample analysis of the PRC corporate tax exposure for the two different forms of establishment. Please note that we have made the following assumptions in our analysis:

1. The annual expenditure for the PRC operation is RMB500,000 per annum.
2. In respect of the WFOE, a service fee is charged to a foreign group company with cost plus 15% as its sole source of revenue.

Analysis of total Business Tax ("BT") and Enterprise Income Tax ("EIT") liabilities under different scenarios

In RMB

		<u>Representative Office ("RO")</u>	<u>Wholly Foreign Owned Enterprise ("WFOE")</u>
Income	(a)	-	575,000.00
Expenses	(b)	(500,000.00)	(500,000.00)
Net profit	(d) = (a) - (b) - (c)	(500,000.00)	75,000.00
Deemed revenue (for RO only)	(e) = (b)/0.8	625,000.00	N/A
Deemed profit (for RO only)	(f) = (e)*15%	93,750.00	N/A
BT@5%	(g) = (a) / (e)*5%	31,250.00	28,750.00
EIT@25% for RO and WFOE	(h) = (d) / (f)*25%	23,437.50	18,750.00
Total tax payable	(i) = (g) + (h)	54,687.50	47,500.00

While there may not be any material potential tax savings, it is still worthwhile for management to consider running the PRC operations in the form of a WFOE versus RO due to the following factors:

1. The flexibility for the WFOE to conduct actual business in China.
2. The ability to lure local employees in China.
3. No restriction on the number of expatriates allowed for the WFOE operations as under the new regulations, only 4 expatriates can be registered as "representatives" for ROs.

Our Services

We can assist in reviewing existing structures and provide our comments and recommendations on our proposed corporate structures from a tax efficiency and operational effective perspective covering:

- Holding structure
- Operating structure
- Organizational structure

We can further assist in the establishment of an appropriate structure in China from the initial location study, structuring advice and the associated tax analysis to the actual formation of the enterprise and obtaining the necessary approval from the relevant Chinese authorities.

RSM NELSON WHEELER TAX ADVISORY LIMITED

RSM Nelson Wheeler's dedicated and experienced tax specialists can:

- Advise on tax efficient holding and operational structures for new cross-border investment, including the formation of Hong Kong and PRC business entities
- Review existing cross-border investment structures, advise on identified deficiencies, quantify any potential exposure from such deficiencies, and further advise on restructuring approach and procedures
- Assist clients to discuss and clarify matters with tax officials, including transfer pricing and advance rulings
- Act as client representative in tax audits and tax investigations
- Provide transaction support services on mergers and acquisitions, including tax due diligence, deal structure advice, tax health checks, related human resources arrangements and other tax compliance and consultation services
- Advise on human resources and structuring employment arrangements in a tax-efficient manner
- Advise on tax equalisation schemes
- Provide tax compliance services for individual and corporate clients in Hong Kong and China

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