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New Tax Changes for Chinese Holding Companies

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## New Tax Changes for Chinese Holding Companies

The use of Holding Companies ("HC") has long been an area of confusion and frustration for many Foreign Invested Enterprises operating in the People's Republic of China ("PRC"). Where as many other countries offer tax incentives and other commercially purposeful reasons for establishing HCs in-country, Chinese legislation has so-far restricted the usefulness of HCs to simply a holding vehicle allowed to invest in lower tier subsidiaries.

At the same time, the tax obligations of HCs were very contentious and not completely transparent. This caused much confusion regarding the tax implications of HCs providing services to its subsidiaries. As such many multinational companies decided to utilise countries such as Hong Kong and Singapore to base their holdings, especially across the Asia Pacific Region.

However, in recent years the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) and the State Tax Authorities have been attempting to clarify many issues for HCs in China, including the tax implications of services rendered and the commercial abilities of HCs.

Recent legislation now allows HCs to distribute goods on behalf of its subsidiaries, borrow a certain amount against Registered Capital and perform a growing number of treasury management functions.

Most recent changes to HCs in China were introduced on September 28, 2002 (**effective in December 2002**) concerning revenue generated through services performed for subsidiary companies. The State Tax Statute # 128 (*Guo Shui Fa #128*) provides clarification on the following issues. Whilst not completely covering all related issues, the greater guidance will provide Foreign Invested Enterprises with some transparency in transfer pricing arrangements and tax deductibility:

- **Revenue from services provided to subsidiaries:** HCs should enter into contracts with each individual subsidiary to which it provides services either based on an "arm's length transaction" principle or using the "Cost Plus" Method to determine amount of 'Deemed Service Revenue'.

State Tax Statute #128 clarifies that this revenue (under either actual or cost plus method) is subject to business tax.

- **Allocation of Deemed Service Revenue between various subsidiaries:** Where a HC

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provides services to a number of subsidiaries which are difficult to individually differentiate, the Deemed Service Revenue should be allocated between the subsidiaries based on the following factors:

1. Registered Capital;
2. Total Investment;
3. Sales;
4. Assets.

- **Cost Plus Method for Deemed Service Revenue:** If a HC uses the Cost Plus Method for calculating deemed service revenue (DSR), either of the following formulae must be used:

$$DSR = \text{Actual Costs} / (1 - \text{Business Tax rate} - \text{Deemed profits rate}) \text{ or};$$

$$DSR = \text{Identified Costs} / 0.9$$

In such cases the Actual Costs are those which are directly attributable to a group of subsidiaries to which the HC provides services, but does not separately identify.

**Note: Deemed profit rate is defined as 5% in the State Tax Statute #128.**

- **Management Fees:** These are specifically prohibited from being charged to the subsidiary.
- **Reimbursement of third party expenses by the HC:** Where a HC engages a Third Party to provide services on behalf of the subsidiary (e.g. Advertising, Marketing), such expenses may be allocated to the individual subsidiaries using the method of allocating Deemed Service Revenue.

The State Tax Statute #128 indicates, however, that the allocation method used by the HC must first be agreed to by the subsidiary and HC via written agreements. Under these circumstances, the expenses are not considered as revenue for the HC and are not subject to business tax.

- **Nondeductible Investment Expenses:** A HC's income can be split between 'Dividend Income' (not subject to taxes), and Investment Income and Business Income (income other than dividend) which is subject to tax (income tax, VAT, business tax etc.).

Previously there was much confusion as to what was deductible against each of the types of income for tax purposes. However, State Tax Statute #128 clarifies many issues:

1. Investment Expenses and losses are not deductible against business income for tax purposes.
2. Investment Expenses and losses are not allowed to be allocated to subsidiaries by HCs.
3. Investment Expenses incurred by a HC must be accurately calculated and can not be less than the minimum amount prescribed by the State Tax Statute #128 formula:

$$\text{Investment Expenses} = \text{Total Expenses of HC} * (\text{Dividends} / (5 * \text{Business Revenue} + \text{Dividends}))$$

In such cases, Business Revenue includes all revenue less dividends.

Whilst the new tax statute certainly provides clarification on a number of issues for HCs, there are still many issues to which answers are inconclusive and treatment seems to be inconsistent. The Statute also raises a number of interesting issues such as:

- Distribution of dividends (which is currently regulated by PRC GAAP) and the deductibility investment expenses against earnings.
- The ability for China HCs to invest in overseas subsidiaries and the treatment for tax purposes.

It is advised that both foreign invested enterprises operating in China and local companies review all inter-company transactions and agreements in light of the above changes. It would appear that the

## 增值税

"Zeng Zhi Shui"

(Value Added Tax)

## 增值税

"Ying Ye Shui"

(Business Tax)

## 消费税

"Xiao Fei Shui"

(Consumption Tax)

## 所得税

"Suo De Shui"

(Income Tax)

principle of "arm's length" is applicable in such inter-company transactions, and the tax authorities are looking to crack-down on inappropriate pricing and profits transfers.

## A recap of Company Legal Representatives in China

### ***What is a Legal Representative in China?***

A Legal Representative (LR) of a corporation is the person who is appointed by the board of directors, as stipulated in the articles of association, and registered with the government administration authorities to exercise the civil rights and assume obligations on behalf of the corporation.

### ***What is the responsibility of a Legal Representative?***

1. Legal representative is responsible for behavior of the corporation.
2. Legal representative must lead the corporation to act, operate and develop within the legal constraints of the jurisdiction.
3. The behavior of the legal representative shall be deemed as the corporation's behavior where he/she purports to act on behalf of the corporation, makes a speech in the name of the corporation, signs or stamps documents related to the corporation and other actions associated with the goings-on of the corporation.

As stipulated under the Company Law in the People's Republic of China, the Chairman of the Board of a limited liability company should be the Legal Representative of that company.

## Company Chops in China

### ***Introduction to Chops in China***

A "Chop" is necessary for approving decisions relating to the operations and management of a company in China and legally authorising documentation.

A Company may hold a wide range of chops in China, each being used for different purposes and applying to different documentation. Whilst the Company Chop is mandatory for every company incorporated in China, there are also a number of chops which only have a very specific scope and power. These chops are not mandatory and may include the Financial chop, Human Resources chop, and the Contract chop. Such 'specific' chops provide company departments with the ability to, for example, enter into contracts on behalf of the company without having to gain the seal of the Company Chop.

### ***Chop types***

- Company chop: The Company chop is often in round in shape with the registered name of a company engraved on the bottom of the seal. Each company must have only one Company chop and the engraved seal must be approved by the Public Security Bureau (PSB). Once the company is successfully registered with the Administration of Industry and Commerce (AIC), a qualified chop-maker (approved by the PSB) must be engaged to produce the Company Chop.

The Company Chop is the most important and powerful chop held by corporation. It provides legal execution for all documents and is at least required when any important documents are signed, issued or to be changed. For example, any changes to corporate documents, opening of a bank account, issuing a certificate for an employee, or altering the name or business scope of the company all require the Company Chop to be legally binding.

- Financial chop: Financial chop is predominately used for issuing a check and processing

transactions with a bank.

- Human Resource chop The Human Resources chop is used where the company signs a labor contract with any of its staff. Many government bodies also require this chop to be stamped on official company documents such as employment proof letters for employee registration purposes.
- Contract chop Contract chop is only used for the purpose of stamping contracts, particularly for trading contracts.

### ***Use and safeguarding of chops***

Generally, a personal signature and the chop are used together during the process of signing a legal document. A document with a signature and stamped with company chop is deemed as approved by the company or the CEO (appointed by Board of Directors to act on behalf of the company), and is legally binding.

Unauthorised and inappropriate use of chops may cause legal problems for the company. In order to prevent anything detrimental to the company, an appropriate chop management system should be in place. The Executive Director or General Manager (if directed by or named by the Company Legal Representative) is ultimately responsible and held legally accountable for the Company's chop management. However, they can assign specific persons to manage the chops, including the delivery, collection and using of chop.

The following principles should be followed for proper use and management of chops:

1. All chops should be used and kept by the persons (positions) as specified by the General Manager and CEO.
2. The chop should be physically kept by the specified person designated by the general manager and should not be passed to others without prior approval.
3. A chop-management-card (or application system) should be established to record details such as the date, user's name, authorization justification and signature of the designated chop-holder. The information about the use and return of chops must be recorded on individual user-cards.
4. The chop-holder should return the chop prior to resigning from or leaving the company.
5. Anyone who wants to use a chop should first seek written approval from the General Manager and CEO.
6. Authorisations approved by the General Manager and the CEO are effective immediately
7. The company should detail specific instances (documents) which require both the chop and authorized signature to be legally valid.
8. The general manager has the full control over all chops.
9. The use and delegation of any 'specific' chops to various company departments should be based on operational and efficiency decisions.
10. The keeper of the chop must take care of the chop, and report the use of the chop to his direct management.

## *"Providing an alternative in China"*

[insights@lehmanbrown](mailto:insights@lehmanbrown) provides updates of the latest taxation and accounting regulations in the People's Republic of China. It is designed to provide you with interesting and informative information to assist in your dealings with China or any China-related issues that you may encounter.

If you do not wish to receive this newsletter, we have provided an UN-subscribe facility below.

LehmanBrown also provides a monthly newsletter *Peeling the Onion* which investigates certain topical issues affecting businesses in China, particularly for those companies and individuals with operations in the PRC, or looking to establish a presence in-country.



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- ▶ Crisis Management in China
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