

# LEHMANBROWN

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## INTERNATIONAL ACCOUNTANTS

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LehmanBrown will be showcasing at the China Expo 2004

27th to 30th June  
Earls Court, London

Come see us at our stand in the Services Section and talk with our experienced staff regarding your current or future plans for doing business in the world's largest and fastest growing nation

Approximately 1,000 exhibitors from all sectors of China's manufacturing will promote goods/ services over this four-day event. This will include a seminar programme of speakers from several UK and Chinese agencies. Service providers such as accounting, legal, investment, universities, telecommunications, shipping and government agencies will cater for all aspects of foreign trade.

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In this issue of insights:

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### Is your Rep Office Compliant? Paying too much tax?

**Are you sure your Representative Office in China is compliant with Chinese taxation regulations?**

**Can your Representative Office be exempt from tax?**

With recent changes in taxation regulations for Representative Offices ("Rep Offices") many foreign companies are discovering that their Rep Office is not compliant with Chinese taxation regulations. Furthermore, many Rep Offices are paying taxes when they are permitted to apply for tax exemption status.

Below is an overview of the taxation regulations regarding Rep Offices:

Representative offices ("ROs") first became subject to tax in 1985. A circular was issued in 1996 (*Guo Shui Fa [1996] 165*) to improve the tax administration of ROs.

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Most ROs are not permitted to perform true business activities or record income, even though many ROs are still subject to tax. The Chinese tax authorities often tax ROs on a "cost-plus revenue with deemed profit" basis. In March 2003, the State Administration of Taxation ("SAT") issued another circular *Guo Shui Fa (2003) No. 28* to clarify the tax treatment of ROs. This circular had a large impact on representative office taxpayers. The circular not only re-defined tax liability of various types of representative offices ("ROs") and the applicable taxation bases, but also made a big change by including ROs of principal suppliers into the tax net under a cost-plus taxation method.

Effective from 1 July 2003, the Circular 28 has ruled out most tax exemption opportunities except for ROs set up by manufacturers, government organizations, international organizations, non-profit seeking organizations and other similar private organizations. Unlike the 1996 circular, the new rules encourage ROs to file their tax returns or activity reports based on their actual activities in China.

The tax base varies according to industry as follows:

ROs with a head office engaged in business advisory, tax advisory, law, accounting, auditing or other types of consulting services will be taxed on an actual basis, and the RO should maintain complete accounting records and be able to properly calculate revenue and taxable income.

ROs whose head offices are engaged in trading or agency activities carry on business activities on behalf of the head office. Such ROs do not enter into agreements with their customers directly. Because the head office normally collects income attributable to these ROs, revenue of the ROs is determined on a "cost-plus basis". Companies engaged in the following service businesses fall into this category:

- o ROs of trading companies or agents that conduct agency activities for the trade of goods;
- o ROs of foreign advertising companies that conduct advertising agency services for their head offices; and
- o ROs of foreign tourist companies that provide services to tourists (e.g., applications for visas, hotel reservations, booking air tickets and organizing tours and tour guides). In the case of ROs carrying on other taxable activities, tax will be imposed on the actual revenue generated, including amounts received by the head office that are attributable to the RO. Annual activity reports should be filed within one month of the year-end if no revenue is generated.

For ROs with head offices that are foreign governments, international organizations, non-profit or nongovernmental organizations, tax exemption applications should be filed with the competent tax authorities. Such applications should include documentation prepared by the tax authorities or government of the home country identifying the nature of the head office. Applications should be reviewed by the competent tax authorities and are subject to the final approval of the SAT.

In a dramatic change, a new circular - *Guo Shui Han [2004] 568* was issued in May 2004 to reinstate the tax exemption status of ROs of principal suppliers. There is a strict definition of principal supplier for this purpose. **A qualified principal supplier must be solely engaged in trading business on its own account and bearing inventory risk.** That is, a supplier, which is partly engaging in trading business, is not qualified for this tax exemption purpose.

This circular reopened the door to tax exemption for some RO taxpayers. Applicants should note that application for such tax exemption could be cumbersome. They will be required to provide a substantial amount of evidence to prove the business model of its head office together with regular reviews on the status. ROs of companies engaging in other types of activities will not be affected by this circular.

ROs of advertising companies or tour companies with business activities should still be taxed on the cost-plus method whereas ROs of consulting companies in relation to business, law, taxation, accounting, audit, etc. are taxed on an actual income basis.

### LehmanBrown's view on accounting and foreign businesses in China

*The following is an excerpt of an interview with Russell Brown which appeared in the July edition of Metrozine magazine (China).*

**Q: Some accounting scandals have emerged in China, especially in the A share listed companies. What are your comments in this phenomena?**

A: Accounting is a professional vocation and, as such, both the profession itself and professionally qualified accountants must uphold the most strict ethical values. China is certainly not ring-fenced against fraudulent accounting scandals or behavior, especially as the pressure for greater profits and to avoid regulatory restrictions increases. As such, like most other nations around the world with professional accounting bodies, accountants in China must look to China's accounting body (CICPA), other regulatory bodies (e.g. China Securities Supervisory Commission, Ministry of Finance) as well as the international accounting bodies for guidance and also to protect them from ethical dilemmas.

**Q: Have you run into an ethical dilemma in your career?**

A: Never. If LehmanBrown was put into a situation whereby a potential client demanded us to undertake unethical or non-compliant behaviour we would turn the business away. Accounting firms win business because people trust their ethical values, as well as accounting knowledge. We believe it is an integral function for accounting firms to assist in the education of accountants, companies and to promote good Corporate Governance in China, especially given China's emergence as a world business centre.

## 增值税

"Zeng Zhi Shui"

(Value Added Tax)

## 营业税

"Ying Ye Shui"

(Business Tax)

**Q: What do you think are the major hurdles for international companies operating in China?**

A: We have looked at hundreds of companies in many industries and of many nationalities. My biggest frustration is China is the lack of standard interpretation of rules by different Government departments and organizations.

The banking system is a typical example of non standardisation of foreign exchange regulations. This is primarily caused due to having a diverse range of banks and localised regulatory bodies operating throughout China - from the State Administration of Foreign Exchange (SAFE), People's Bank of China, the big four banks, foreign banks, policy banks and other commercial banks. Additionally you have both the tax bureau and SAFE involved in overseas payments, with the majority of regulations being interpreted at local level. We have seen many cases where such interpretations between locations are inconsistent and this can cause huge uncertainty and lack of transparency for Foreign Companies operating in China.

## "Providing an alternative in China"

[insights@lehmanbrown](mailto:insights@lehmanbrown) provides updates of the latest business news, 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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