

New Regulation on Tax for Non-resident Enterprises

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On 20th February 2010, the China State Administration of Taxation (SAT) issued tax circular Guoshuifa [2010] No.18 (Circular 18), entitled *Provisional Regulations on the Administration and Collection of Taxes for Representative Offices of Foreign Enterprises*, and tax circular Guoshuifa [2010] No.19 (Circular 19), entitled the *Administrative Measures for the Collection of Corporate Income Tax on Non-Tax Resident Enterprises on a Deemed Basis*. These two Circulars are a clear indication that the Chinese authorities are strengthening tax collection and administration on Non-Tax Resident Enterprises (Non-TREs). We have highlighted the main points of Circular 19 hereafter with the key points of Circular 18 highlighted in a separate e-newsletter.

Highlights of Circular 19

Circular 19 shall apply to Non-TREs as defined in paragraph 2, Article 3 of Corporate Income Tax (CIT) Law. Detailed and specific regulations on the tax calculation for representative offices of foreign enterprises should be referred to other relevant regulations. Circular 19 shall come into effect on 20th February 2010.

1. Tax calculation methods

- **Actual profit method**

Non-TREs should maintain accurate and complete accounts based on effective and legitimate vouchers in accordance with the relevant laws and regulations to calculate the actual taxable income arising from China, and the taxable income should be commensurate with the functions and risks undertaken by the Non-TREs.

- **Deemed profit method**

If a Non-TRE is unable to accurately calculate the taxable income on an actual profit basis due to inaccurate or incomplete accounts or other reasons, the tax authorities are entitled to determine the taxable income based on one of the following deemed profit methods.

Deemed profit method	Applicable situation	Applicable formula to calculate taxable income
Total Revenue Method	Where the taxpayer can accurately calculate its revenue or the total revenue may be reasonably determined but the tax payer cannot accurately calculate its costs and expenses	Taxable income = total revenue x deemed profit rate
Cost Plus Method	Where the taxpayer can accurately calculate its costs and expenses but cannot accurately calculate total revenue	Taxable income = total costs and expenses / (1 – deemed profit rate) x deemed profit rate

Expenditure Plus Method	Where the taxpayer can accurately calculate its total expenditure but cannot accurately calculate its total revenue or costs	Taxable income = total expenses / (1 – deemed profit rate – business tax rate) x deemed profit rate
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2. Deemed profit rates

In cases where the above deemed profit methods are adopted, the profit rates deemed by tax authorities shall be as follows:

Business	Deemed Profit Rate
Provision of engineering work, design and consulting services	15% - 30%
Provision of management services	30% - 50%
Provision of other services or business activities other than services	No less than 15%

If the tax authorities have evidence to support the case that a Non-TRE's actual profit rate is obviously higher than the above, a deemed profit rate higher than the high end of the range can be used to calculate the taxable income of the Non-TRE.

3. Special Occasions

- In the event that a Non-TRE enterprise enters into an equipment or merchandise sales contract with a Chinese resident enterprise and at the same time provides after-sale services in China such as, installation, assembly, technical training and supervision, the service fee shall be clearly indicated in the sales agreement and shall be reasonable, otherwise, the tax authorities can determine the service income by reference to the price of the same or similar services. Where reference is not available, the service income should be calculated based on the principle that the service income should be no less than 10% of the total contract value.

- In the event that services are provided both within and outside China, onshore and offshore service income shall be apportioned according to where the services were actually performed, and the service income arising from China should be subject to Chinese CIT. The tax authorities may require the Non-TREs to provide evidence to support the truthfulness and reasonableness of the basis for the allocation; in case the Non-TREs are unable to provide the evidence as required, the service would be deemed as 100% performed in China for CIT calculation purpose.

- In the event that a Non-TRE earns income from business activities that are subject to different deemed profit rates, it must separately calculate the taxable income of those activities with the applicable deemed profit rates. Otherwise, the highest deemed rate will apply to the total income.

Non-TREs are required to complete the Assessment Form for Tax Calculation Method for Non-TRE Enterprises (the Form), and submit this to the tax authorities for approval. The tax authorities should send a notice to the Non-TRE within 15 days after receiving the Form if the tax authorities disagree with the tax calculation method as indicated in the Form.

LehmanBrown Observations

The deemed profit rate for Non-TREs used to be 10% - 40% before the issuance of Circular 19. With the issuance of Circular 19, the tax burden for Non-TREs would significantly increase where a deemed profit method is adopted.

In the meantime, for many of the Non-TREs the actual profit method is either not feasible or would significantly increase the operational and administrative costs. Foreign enterprises are thus suggested to re-assess and balance the tax liabilities and administrative costs in accordance with Circular 19. Furthermore, after-sales services and business activities, both onshore and offshore services, could be subject to different deemed profit rates. Therefore, there are potential risks given that the Non-TREs should be responsible for provision of accurate records and evidence to support the calculation of the taxable incomes.

Non-TREs are advised to plan in advance and to seek the opinions of the governing tax authorities to ascertain the corresponding tax liabilities.