

## New Taxation Rules for Representative Offices of Foreign Enterprises in China

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On 20th February 2010, the State Administration of Taxation (SAT) issued Circular Guoshuifa [2010] No.18 entitled Provisional Measures for Tax Collection and Administration of Representative Offices of Foreign Enterprises (Circular 18), to clarify and update tax rules relating to the taxation of representative offices (ROs) in China.

Circular 18 provides the landscape of taxation rules for ROs covering Corporate Income Tax (CIT) calculation, Value Added Tax (VAT) and Business Tax (BT) treatment, tax registration and filings, and procedures for tax treaty benefits claiming etc. This circular shall come into effect from 1st January 2010.

### Highlights of Circular 18

1. Representative Offices need to perform tax registration within 30 days after the relevant business registration or approval is obtained. Amendment or tax de-registration are required when the contents of the tax registration have been changed or the RO ceases operations. ROs are required to report CIT on their liquidation income before tax de-registration.
2. The profit attributable to an RO should be subject to CIT. Where an RO conducts VAT and BT taxable activities the RO shall be subject to VAT and BT that are calculated based on the relevant tax regulations. ROs are required to report CIT and BT on a quarterly basis, and the VAT filing period should follow the relevant VAT regulations.
3. ROs should calculate their tax liabilities based on one of the following methods:

- Actual profit method

ROs are required to maintain accounting books based on official and valid vouchers to ascertain the actual revenue and profit, the reported profit should be commensurate with the functions and risks undertaken by the RO.

$CIT = \text{Actual taxable profit} \times \text{CIT rate}$

$BT / VAT = \text{Actual taxable income} \times \text{applicable BT/VAT rate}$

- Deemed Profit methods

The Chinese tax authorities shall adopt “deemed profit methods” to determine an RO’s taxable income if an RO cannot correctly compute its revenue and costs, or is unable to use the actual profit method to ascertain the tax liabilities. The deemed profit rate in the calculation should not be less than 15% according to the new requirement set forth in Circular 18.

- For ROs that can accurately compute the operating expenses but cannot accurately calculate the revenue or costs, expense-plus method should be used:

Deemed revenue = expenses for the period / (1 – deemed profit rate – applicable BT rate)

CIT = Deemed revenue x deemed profit rate x CIT rate

BT/VAT = Deemed revenue x applicable BT/VAT rate

- For ROs that can accurately compute the revenue but cannot correctly calculate the costs and expenses, actual revenue and deemed profit method should be used:

CIT = Actual revenue x deemed profit rate x CIT rate

BT/VAT = Actual revenue x applicable BT/VAT rate

4. Circular 18 has invalidated the previous tax circulars governing various tax treatments for ROs, and the local tax authorities will no longer accept CIT exemption applications under the old rules. They are likely to stop previously approved exemptions as their registrations become due for renewal.

5. ROs that believe they are eligible for an exemption from CIT pursuant to relevant tax treaties may apply to the tax authorities for the exemption in accordance with the Administration Measures on the Application for Preferential Treatment under a Tax Treaty by Nonresidents (Guoshuifa [2009] No.124). Such ROs are also required to file tax returns within the period as mentioned above.

#### LehmanBrown's Observation

China tax authorities have widely adopted deemed profit methods as a tax calculation basis for existing ROs. With the issuance of Circular 18, the existing ROs will be facing a heavier tax burden with the deemed profit rate being raised from 10% to a minimum of 15%. The following example illustrates how much the total CIT and BT will be increased for an RO, which is taxed based on the expense-plus method.

	Formula	Old rules	Circular 18
Total operating expenses	A	100	100
BT rate	B	5%	5%
Deemed profit rate	C	10%	15%*
CIT rate	D	25%	25%
Deemed revenue	$E=A/(1-B-C)$	117.65	125
BT payable	$F=E*B$	5.88	6.25
CIT payable	$G=E*C*D$	2.94	4.69
Total tax burden based on the expenses	$H=(F+G)$	8.82	10.94
% increase in total tax burden		$(10.94-8.82)/8.82*100\%=24\%$	

\*the minimum deemed profit rate per Circular 18

A company establishing an Representative Office in China is relatively simple as there is no registered capital requirement, simplified application process and ongoing compliance requirements and therefore costs are cheaper. Consequently, it is common for foreign investors to initially register an RO and use this as a stepping-stone when starting to do business with China. According to our above illustration, the total tax burden will be increased by at least 24% following the issuance of Circular 18.

It should also be noted that generally a Representative Office cannot be converted to a company and that deregistration can take between six and twelve months. It is therefore important that foreign enterprises take this taxation into consideration when reviewing their longer term business plans relative to China.

A comparison of a Representative Office and a Foreign Invested Commercial Enterprise (FICE) is detailed in our Appendix for your reference.

For more information, please contact us at [beijing@lehmanbrown.com](mailto:beijing@lehmanbrown.com).

**Appendix**

Comparison of RO and FICE

	RO	FICE
<b>Business perspective</b>	<p><u>Pros</u></p> <ul style="list-style-type: none"> <li>Setting up procedure is relatively simple and could be accomplished in a relatively short period, normally 1-2 months;</li> <li>No registered capital is required;</li> <li>Tax compliance requirements are in general simple, requiring less administration effort.</li> </ul>	<p><u>Pros</u></p> <ul style="list-style-type: none"> <li>A FICE may conduct import, export, domestic purchase and sales, and after-sales services, etc;</li> <li>It can generate sales and can issue official invoice (Fapiao) by itself;</li> <li>It can employ Chinese employees directly;</li> <li>A FICE is a legal person with limited liabilities.</li> </ul>
	<p><u>Cons</u></p> <ul style="list-style-type: none"> <li>The RO's business scope is very limited. Strictly speaking, it cannot engage in any business operating activities directly. Only auxiliary and preparatory activities are allowed;</li> <li>It cannot have sales revenue and cannot issue official invoice (Fapiao) by itself;</li> </ul>	<p><u>Cons</u></p> <ul style="list-style-type: none"> <li>Setting up procedure is relatively complicated and takes longer time, normally 2-3 months;</li> <li>Registered capital is required.</li> </ul>

<p><b>Tax perspective</b></p>	<ul style="list-style-type: none"> <li>• It cannot employ Chinese employees directly, hence has to pay HR agent certain service fee for each Chinese employee hired;</li> <li>• An RO is not a legal person.</li> </ul> <p>Generally, taxes are paid based on deemed revenue:</p> <ul style="list-style-type: none"> <li>• BT – 5% of deemed revenue;</li> <li>• CIT – 25% of 15% (deemed profit margin no less than 15% according to Circular 18) of the deemed revenue;</li> <li>• Stamp duty;</li> <li>• River maintenance and protection surcharge (if applicable).</li> </ul> <p>[Trading by the parent of the RO would be subject to VAT on import and export and possible import duties on import, which need to be taken into account when review overall business model and structure]</p>	<ul style="list-style-type: none"> <li>• Tax compliance requirements are relatively complicated.</li> </ul> <p>Taxes are paid based on actual revenue and profit:</p> <ul style="list-style-type: none"> <li>• VAT (general tax payer) – 17% for domestic sales, for export the export refund rate varies;</li> <li>• CIT – 25% of actual profit;</li> <li>• Stamp duty;</li> <li>• City maintain and construction tax;</li> <li>• River maintain and protection surcharge (if applicable);</li> <li>• WHT on dividends.</li> </ul>
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