



Tax Alert

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China Tax on Representative Offices of Foreign Enterprises in China – New Rules

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On 20 February 2010, the State Administration of Taxation (“SAT”) issued Guoshuifa (2010) No. 18 (“Circular 18”) on the Provisional Measures of Collection and Administration of Tax For Representative Offices of Foreign Enterprises in China. The Circular 18 is applied retrospectively from 1 January 2010.

Circular 18 emphasizes that a representative office (“RO”) of a foreign enterprise should report and pay Enterprises Income Tax (“EIT”) based on its attributable income, and pay Business Tax (“BT”) and Value Added Tax (“VAT”) based on its taxable income and according to the relevant regulations.

In general, a foreign company is allowed to set up RO(s) in China. The RO can, subject to approval, represent its head office in conducting business liaison activities, product introduction, market research and technology exchange in respect of activities within the scope of business of its head office. After the open-door policy adopted by Chinese government, setting up of a RO as an initial step for penetrating into the China market has been utilized by many foreign companies. In general, a RO is prohibited from engaging in direct profit-making activities based on the regulations laid down by the relevant governing authorities. However, from a tax collection perspective, the Chinese tax authorities would request the ROs to file tax returns and pay taxes based on their attributable income and / or taxable income.

Circular 18 abolishes the tax circulars previously issued on tax administration for ROs and clarifies the tax registration procedures and methods for taxing ROs in details. A brief summary of the basic rules regarding computation of taxable income for ROs as stated on the Circular 18 is set out below.

A RO should keep proper books of accounts, based on the matching principle regarding actual functions undertaken and risks assumed, for calculating accurately its taxable income and the tax payable. Tax filing with the tax bureau in charge must be made within 15 days from the end of each quarter and have the EIT and BT paid. The RO should also follow the relevant VAT regulations and the prescribed tax filing time frame to pay VAT.

Where accounting records are incomplete and thus income and costs / expenses cannot be properly calculated, the tax bureau is entitled to use either one of the two methods below to assess the taxable income of a RO:

- (1) Derivation of income based on operating expenses incurred, where the RO keeps proper and accurate records on operating expenses, but not income:

Income = Operating Expenses of the period / (1-deemed profit rate - business tax rate)

EIT payable = Income x deemed profit rate x EIT rate

- (2) Deemed taxable income method based on total income, where the RO keeps proper and accurate records on revenue but not costs and expenses.

EIT payable = Total income x deemed profit rate x EIT rate

The deemed profit rate cannot be lower than 15%.

Circular 18 further states that the EIT relief under relevant tax treaties is applicable to a RO upon application based on the relevant procedures. However Circular 18 requires the China tax authorities not to accept applications for an EIT exemption and to review the tax treatments for those ROs that were granted with tax exemptions.

According to the existing practice and requirements in China, the accounts of a RO are required to be audited annually. The applicable BT rate in general for RO is 5% on its income or deemed income which is subject to BT.

In conclusion, the tax regulations applicable to ROs have become much more stringent in view of the increased deemed profit rate (i.e. raising from 10% to a minimum of 15%) and the restrictions imposed on the application of the EIT exemption for ROs. Foreign investors should review their operation structures in China if ROs have been used as operating vehicles for China market.

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