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China Issues New Tax Rules For Representative Offices Of Foreign Enterprises

On February 20, 2010, China's State Administration of Taxation (the "SAT") issued a *Notice On Interim Measures For Tax Administration Of Representative Offices Of Foreign Enterprises* (Guoshuifa [2010] No. 18, also referred to as "Circular 18"). Circular 18 states measures governing enterprise income tax (EIT), business tax, and value added tax (VAT) on representative offices of foreign enterprises (including those in Hong Kong, Macau and Taiwan). It takes effect retroactively as of January 1, 2010.

Main Points

Enterprise Income Tax

According to Article 6 of Circular 18, a legally registered representative office of a foreign enterprise must set up accounting books pursuant to relevant laws, regulations and rules. Furthermore, it must maintain the books based on legitimate vouchers, calculate the amount of its taxable income and tax liabilities according to the principle that function should match the risks taken, and declare EIT and business tax amount 15 days before the end of a quarter.

In a case where a representative office cannot correctly keep the books or calculate its costs and expenses, or where it does not objectively declare taxes as required, the governing tax authority can determine its taxable income by either of the two following methods:

1. *Expenditure-Based Method* – This method applies to representative offices that can correctly calculate its expenditure on operation but not its gross income or costs and expenses.

The formulas are:

Deemed gross income = Expenditures for operation of current period / (1 – Deemed profit rate – Business income tax rate;

Deemed payable tax amount = Deemed gross income x Deemed profit rate x EIT rate.

Expenditures for operations include: (i) salaries, bonuses, allowances, welfare allowances paid inside and outside of China to its personnel; (ii) payments on equipment and immovable properties; (iii) communication expenses; (iv) traveling and accommodation expenses; rental payments for equipment, and other expenses. The other expenses include: (i) cost of samples (including its transportation) purchased by the representative offices within China for the head quarter; (ii) storage and customs clearance expenses incurred within China when samples are shipped to China; (iii) interpretation and translation expenses for personnel of the headquarter who visit China; (iii) bid documents expenses for projects in China paid by the headquarter on behalf of its representative office.

The cost of purchasing fixes asset and the cost of decoration when an office is opened or relocated will be treated as one-time expenditures for operation when occurred. The expense that is actually incurred for marketing and public relationship is treated as an expenditure for operation. In addition, interest income cannot be used to offset against the expenditures for operation.

The following are excluded as expenditures for operation: Charitable donations made in cash within China, late payment fees and fines paid in Cash by the representative offices, and expenses unrelated to the representative office's business and paid by it on behalf of the head quarter.

2. *Gross Income-based Method* – This method should be applied when an representative correctly calculates its gross income but cannot accurately compute its costs and expenses. The formula is as follows:

Deemed EIT = Gross income x Deemed profit rate x EIT Rate

According to Circular 18, the new deemed profit rate is 15%, amending the previous rate of 10% which was used for more than a decade. The actual profit-based method will replace the expenditure-based method and the gross income-based method if a representative office can accurately keep the books and compute its taxable income and gross income correctly.

VAT and Business Tax

Under Circular 18, representative offices that engage in VAT and taxable business activities will be subject to VAT and business tax according to the relevant laws and regulations. According to the relevant Chinese laws, VAT is imposed on sales of merchandise services related to processing, repairing and assembling and import of goods.

Other Matters

Detailed document list and procedure for tax registration and fillings are also provided for by Circular 18. In addition, representative offices seeking tax treaty benefits must complete tax registration and filings pursuant Article 6 of Circular 18, and must follow the applicable tax treaty and Guoshuifa [2009] No. 124 regarding nonresidents' eligibility for tax treaty treatment.

Guishuifa [1996] No. 165, Guoshuifa [2003] No. 28 and Guoshuihan [2008] No. 945 are abolished upon Circular 18's effective date of January 1, 2010. Local tax authorities no longer accept applications for EIT exemption by representative offices, but they will continue to handle the EIT exemption applications that have already been approved.

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