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**Llinks Corporate Bulletin**
April 2010

# Corporate Income Tax Considerations for Foreign-Invested Partnership Enterprises

**By David Yu and Clare Lu**

The *Administrative Measures on the Establishment of Partnership Enterprises in China by Foreign Enterprises or Individuals* （“Administrative Measures”） has become effective on 1 March 2010. As a new vehicle for foreign investors entering into Mainland China, the partnership enterprise is an appealing option due to its “allocating before taxing” characteristic. Considering that foreign investors typically structure investments in the form of legal persons (e.g. corporations), we will discuss in this article the possible PRC corporate income tax (“CIT”) implications of foreign-invested partnership enterprises (“FIPEs”) and foreign corporate partners.

## Relevant Regulations

Currently, there are no specific laws or regulations on the assessment of income tax against FIPEs in Mainland China. The major rules that may provide reference are: *Provisions of Levy of Individual Income Tax on Investors of Wholly Individual-owned Enterprises and Partnership Enterprises* (Caishui 2000 No. 91) (“Circular 91”) and *Notice on Issues Concerning the Income Tax Levied on Partners of a Partnership Enterprise* (Caishui 2008 No. 159) (“Circular 159”).

## How are an FIPE and its Foreign Partners Taxed?

➢ Is an FIPE required to withhold income taxes for its foreign partners?

Circular 91 and Circular 159 both stipulate that a partnership enterprise (including an FIPE) is not an income taxpayer and that the partners shall report and pay income tax. Partners that have legal-person status or are otherwise qualified organizations, i.e. corporate partners, shall pay CIT. However, neither circular stipulates whether a partnership enterprise is required to withhold income tax for its partners.

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Generally, a partnership enterprise needs to withhold income tax for its individual partners but not for its corporate partners. In our view, under the circumstance where the taxability of a foreign corporate partner is determined based on whether or not the foreign corporate partner is deemed to have a permanent establishment ("PE") in China (please refer to details below), and that a foreign investor is deemed not to have a PE in Mainland China, the tax authorities may require an FIPE to withhold tax for the foreign partner. In regards to a foreign investor who constitutes a PE in China, based on our experience, the tax authority may nevertheless request an FIPE to, in the interest of tax administration, withhold and pay taxes on behalf of the foreign investor.

- Where should partners file their taxes?

  The relevant laws and regulations are unclear as to the filing place for corporate partners. In some cities, corporate partners are granted options to declare their income tax with the in-charge tax authority where the partner is located or where the FIPE is registered. For the foreign partner of an FIPE, in our view, income tax is generally required to be filed with the in-charge tax authority where the FIPE is registered, unless the foreign partner is registered for tax purposes elsewhere in Mainland China.

- What is the calculation for taxable income?

  Circular 159 stipulates that partners should be taxed on the aggregation of business operation income and other income. In calculating its income liability, a corporate partner cannot offset its taxable income by using the losses of the partnership enterprise. In other words, the partnership enterprise's losses could only be carried forward at the partnership level. Additionally, partners have to pay income tax even before the distribution incomes are realized, thus possibly creating a great deal of cash flow pressure to partners.

## Other Outstanding Material Issues

Aside from the aforesaid issues that are related to tax filing formalities and timeframes, we think that, due to the delay of prevailing tax legislation, there are many material tax issues left unaddressed regarding the FIPE form, especially with respect to the taxation of foreign investors:

- What is the nature of income derived by foreign partners from an FIPE? For example, if a partner makes foreign investments in a company through a partnership, is the dividend income distributed by the partnership still treated as dividend in the hands of the partner?

- How are foreign investors taxed on distributions received from a partnership enterprise? In our view, a foreign-invested cooperative venture capital enterprise with non-legal–person status (if electing the "allocating before taxing" method) is taxed similarly to an FIPE. Under the old CIT regime,[1] the foreign investor of a foreign-invested cooperative venture capital enterprise is taxed depending on whether it constitutes a PE in Mainland China. In practice, such principle might be temporarily applied to FIPEs, but has yet to be further clarified by the relevant tax provisions.

The Administrative Measures is a supplementary legislation of the *PRC Partnership Enterprise Law*, therefore some of the general principles of the *PRC Corporate Income Tax Law* might not be applied to FIPEs. In regards to the lack of clarity, the tax authorities may issue additional implementation rules regarding these pending issues in the near future which should be noted.

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This article was first published in *China Legal Review, April 2010.*

1 *The Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises* that was effective prior to 1 January 2008.