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New Administration and Tax Filing Rules for Representative Offices of Foreign Enterprises

By David Yu and Clare Lu

On February 20, 2010, the State Administration of Taxation issued the Guo Shui Fa [2010] No.18 ("Circular No.18"), which addresses the question of how representative offices of foreign enterprises in mainland China ("ROs") shall file and pay PRC taxes. In addition, on January 4, 2010, the State Administration for Industry and Commerce as well as the Ministry of Public Security jointly issued the Gong Shang Wai Qi Zi No.4 ("Circular No.4"), to strengthen the registration administration of ROs. The rules stipulated in the above circulars, regarding registration and taxation administration, differ widely from previous rules. In light of such, foreign enterprises should reassess whether their PRC ROs can achieve their intended business purposes in mainland China.

Overview of Regulations

The abovementioned circulars provide:

- An RO shall only engage in business activities within the scope provided under its registration certificate. Penalties may be imposed against an RO for operating without a license if it engages in business activities and derives revenues in various forms outside the aforesaid scope;

- The number of an RO's representatives should correspond to its operational activities, and in general shall not exceed four (including the chief representative);

- An RO should well keep books, lawfully maintain accounting records based on valid vouchers, and correctly calculate its taxable income in accordance with the principle of proportionate functions and risks, then accordingly file and pay corporate income tax ("CIT"), business tax ("BT"), and value added tax ("VAT"); and

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- Tax authorities will no longer accept CIT exemption applications for ROs, and will clean up ROs who have obtained approvals for taxation exemptions.

Our Comments

- Number of representatives and scope of operation: Circular No. 4 stipulates that an RO should have limited representatives, and the RO whose actual activities exceed the scope listed in the registration certificate may be punished for "operating without a license". These rules may have a material impact on an RO's current business model.

- CIT assessment methods: the CIT assessment methods under Circular No. 18 are consistent with prior methods. However, the methods stated in Circular No.18 are no longer established based on the specific industry in which the RO engages. Thus, in practice, further investigation is needed to determine the specific criteria of various local tax authorities, and to determine whether it is necessary to re-evaluate the ROs' assessment methods.

- Principle of proportionate functions and risks: Circular No. 18, for the first time, requires the RO to follow the principle of proportionate functions and risks when calculating its taxable income. In our view, it implies that transactions between the RO and its head office should comply with the arm's length principle, where relevant incomes, costs and expenditures should be accounted at fair prices. However, further regulations regarding how such principle will be practically implemented are still needed.

- RO as a VAT taxpayer: Circular No. 18 provides, for the first time, that an RO shall file and pay VAT when it engages in business activities which qualify as VAT taxable activities. However, in practice, further confirmation is needed to address the circumstances under which an RO will be liable for VAT, to address how an RO may undertake the taxpayer status, and to address the applicable tax rate imposed against an RO, etc.

- Deemed profit rate changes: Circular No. 18 raises the deemed profit rate from the original 10% to no less than 15%, rendering an increase to actual tax burden of ROs of more than 1.25% under the cost plus method (i.e. 5% nominal increment of deemed profit rate × 25% CIT rate). Under this change, foreign investors should re-evaluate the actual tax burden of their ROs, and reassess their business structures in mainland China accordingly.

- Application for tax exemption: Tax authorities will no longer accept or approve any CIT exemptions. At the same time, Circular No. 18 does not clarify whether an RO may apply for BT and VAT exemptions based on relevant tax regulations. In practice, it remains to be seen whether there are other ways for ROs to apply for taxation exemptions.

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In summary, from our view, under the circumstances of the policy changes towards stricter tax collection and administration against non-resident taxpayers, the promulgation of Circular No. 18 and Circular No. 4 means that foreign enterprises may need to reassess their actual business requirements and structures in mainland China, to re-evaluate the advantages and necessities of investing through an RO, and to consider adopting alternative investment vehicles (such as foreign investment limited partnerships) in place of ROs, in order to achieve their business goals in mainland China.

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