LEGAL UPDATE

Edition: August 2010

Representative Offices – The New Tax Treatment and Administrative Regulations

Representative Offices (ROs) have, for some time, been a popular form of business vehicle for businesses looking to test the PRC market or for maintaining a presence in China without committing extensive resources. However this year, the Chinese government has tightened both the administration rules governing ROs and the collection of enterprise income tax from them in a move to deter them from abusing the regulations by, amongst other things, engaging in ultra vires activities.

Recent Restrictions on RO's

In January 2010, the State Administration for Industry and Commerce ("SAIC") and the Ministry of Public Security jointly introduced the *Notice of Further Strengthening the Registration Administration of Foreign Enterprises' Representative Offices* (the "Notice") which places more stringent requirements on ROs. The main changes brought about by this new rule can be summarized as follows:-

Matter	Position before Notice	Position after Notice
Existence before establishment of RO	No track record required	Foreign company must have existed for at least 2 years before establishing a RO
Incorporation documents	Requirements depend on location	Must be notarized and attested by Chinese embassy in head office jurisdiction
Renewal of registration certificate	Requirements depend on location	Must prove existence of immediate head office when renewing.

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Registration certificate	Varied depending on location e.g. could be for 1 – 10 years	Valid for only 1 year
Number of representatives	Unlimited	No more than 4 representatives including the chief representative and expatriates.
Penalty	Not clarified	Provincial branches of SAIC can penalize ROs for collection of funds from various sources as it is deemed to be “Operating without a Business License”.
Compliance registration	No system used	ROs will be supervised and failure to comply on any issues, e.g. not renewing Registration Certificate will be recorded in the system
Investigation of site	Unspecified	Provincial branches of SAIC must inspect RO office premises within 3 months of issuance of Registration Certificate

Comments

These changes are likely to affect each RO or potential RO in different ways. Whilst the changes aim to ensure consistency of the process across the different localities, they seem to be making the process of establishing a RO more difficult, at a time when the Chinese government is looking to attract more foreign investment.

The ability of new or start-up companies to test the water in Chinese markets by setting up a RO has been wholly restricted if they have not existed for the 2 year period required to set up a RO. The cap on the number of Representatives which a RO is allowed will adversely affect businesses which require more than 4 Representatives, of whichever nationality, or 4 expatriates, (who must register as either a Chief Representative or a Representative to get a valid visa and work permit) to operate. This amendment therefore acts as a restriction on the size of ROs. In addition, ROs are now under greater scrutiny with more onerous supervision and site-visits by SAIC and are open to penalties if they are found to be engaging in ultra vires activities or collecting funds from various sources.

Taxation Changes

On February 20, 2010 the State Administration of Taxation issued the *Tentative Measures for the Tax Administration of Resident Representative Offices of Foreign Enterprises* (the "Tentative Measures") and additional supporting administrative rules. The Tentative Measures seek to clarify and update the taxation policies affecting ROs in China but simultaneously introduce the following alterations:-

- **Deemed Amount Method**

The Tentative Measures put emphasis on tax files of ROs using the "actual basis", on the assumption that they are established to carry on profitable business activities in China. ROs are only permitted to apply the deemed amount methods, if they are unable to maintain accounting records to calculate their taxable income.

Method of Taxation	**Calculation**
Expense-plus Method - applicable when RO can accurately ascertain expenses but not revenue/ cost	• Deemed gross revenue = expenses for period / (1 – deemed profit rate – applicable Business Tax ("BT") rate) • Corporate Income Tax ("CIT") = Deemed gross revenue x deemed profit rate x CIT rate • BT = deemed gross revenue x applicable BT rate
Actual Revenue Deemed Profit Method	• CIT = Actual gross revenue x deemed profit rate x CIT rate

- applicable when RO can accurately ascertain revenue but not cost/ expense	• BT/Value Added Tax ("VAT") = Taxable revenue x applicable BT/VAT rate

As well as restricting the use of the deemed amount method, the Tentative Measures also increase the deemed profit rate used in the calculation from 10% to a minimum rate of 15%, depending on the industry involved. The deemed profit rates for each industry are detailed in Circular 19 *The Administrative Measures for the Collection of Corporate Income Tax on Non-Resident Enterprises on a Deemed Basis,* and are subject to the discretion of the tax authorities. If the tax authorities have evidence to suggest that the actual profit rate of a Non-Resident Taxpayer (i.e. a foreign company or part of a foreign company which has been incorporated abroad and which has no business activities nor effective management in China) is higher than the prescribed rate in Circular 19, they may raise the deemed profit rate. As ROs have been categorized as Non-Resident Taxpayers, following the New PRC Enterprise Income Tax Law, it can be presumed that these regulations will apply to them also.

Comments

The old deemed profit rate of 10% tended to be lower than the actual profit rate of the ROs and so ROs were in an advantageous position for tax purposes. However, in stark contrast, the new rate is suspected to increase the tax burden on ROs dramatically by at least 20%.

In addition, as the 15% rate is only a minimum rate and may be increased up to 50% at the discretion of the local tax authorities, this amendment may lead to uncertainty for those looking to invest in China and could result in regional variations.

- **Exemptions**

Previously, ROs may have been entitled to tax exemption status where they only conducted activities such as market research, liaison and other preparatory sales and marketing for their head office's products.

Under the Tentative Measures however, there will be no more tax exemptions for ROs unless there is a relevant tax treaty or agreement. Tax treaties allow ROs to qualify for tax-exemption status where they do not constitute a fixed place of business through which an enterprise's business is carried on in part or in whole (a "Permanent Establishment") and accordingly, where a RO's functions include only preparatory and auxiliary activities in China, the RO will not be deemed to be a Permanent Establishment. In the event that a RO is eligible for favorable treatment under a tax treaty, they must file an application as a Non-Resident Taxpayer under the *Notice of the State Administration of Taxation on Printing and Distributing the Administrative Measures for Non-residents to Enjoy the Treatments on Income under DTA (Trial) Circular Guoshuifa [2009] No.124*.

Claiming tax exemption status in China for ROs was not particularly easy before the Tentative Measures and for many there will be little impact from the removal of these.

Conclusion

Overall, ROs will remain a practical approach to testing the Chinese markets however the new regulations as a whole will have a significant impact. Head offices and ROs should review their structures to check that they are compliant with the regulations and it would be advisable for them to conduct an analysis of their tax records and to consult with local tax bureaus for clarity on the appropriate tax position.