



## Briefing Paper

### A tax blow for representative offices

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On 20 February 2010 the State Administration of Taxation (SAT) issued Guoshuifa [2010] 18 (the “Circular”), a circular outlining a new tax treatment for representative offices (ROs) of foreign enterprises in China. The Circular replaces several older circulars related the taxation of ROs and the changes are quite significant.

#### **Past Tax Treatment**

ROs were never intended to be an investment vehicle through which to operate a business in China, but were meant to be a liaison office of foreign enterprises that have business interests in China. In such circumstances, ROs would never be taxed but rather the head office would be taxed in China on any income sourced from China. Over time, because of the cheap start up costs and a failure of China to strictly enforce the requirements, many foreign investors used ROs to run businesses. Accordingly, a special model for taxation of ROs was developed. ROs were deemed to have a certain profit (usually 10% of expenses) based upon their expenses incurred. This deemed income was then subject to income tax at the relevant rate. Expenses genuinely relating to production, manufacture or sales of the head offices products, liaison work and market research were exempt from tax. Often ROs would be given outright exemptions on the basis that all their expenses fell into the exempt category, even if they did not).

#### **End of Tax Exemption for ROs**

In the past, a large number of ROs were exempt from tax in China. The Circular now indicates that the exemption for ROs is to end – both for ROs established in the future and currently existing ROs that are tax exempt. This means a radical shift in profitability for foreign enterprises that had operated in China with such an exemption.

#### **The Taxable Income of the RO**

The Circular provides three bases on which the taxable income of a RO is determined; the actual method and two deemed methods. The actual method will apply where the RO can adequately prove gross income and expenses. A similar actual method applied in the past, but in practice it was only used with respect to professional services firms. It is not clear whether the actual method under the Circular will be similarly limited. The two deemed methods apply where the income of the RO or the expenditure of the RO cannot be adequately established. In such, circumstances the Circular deems the taxable income of the RO to be a minimum of 15% of expenditure or gross income (whichever applies).



## Further Information

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Under the previous system, the deemed taxable income was 10% so the new Circular will lead to a higher level of taxable income for ROs using the deemed method. The fact that the deemed profit rate is a minimum amount means that local tax officials will have the discretion to impose a higher rate. Once the deemed taxable income is determined, it will then be taxed at the applicable EITL tax rate, which as indicated above will likely be 25%. In terms of this it should be noted that interest expenses cannot be deducted from appropriation expenditure. As a result of all this, where minimal profit is being made by the RO, or the operations are expected to be partially funded by financing, the Circular provides a strong impetus to keep accurate and sound accounting records so that the actual method can be applied.

### Repeal of Guoshuifa (1996) 165

One of the more significant aspects of the Circular is that it repeals Guoshuifa (1996) 165 (“**Circular 165**”) without addressing matters covered in that circular. Circular 165 indicated what activities of a RO would be taxable and what activities would not be taxable. Non-taxable activities included work carried in relation to the production, manufacturing and sale of the head office’s products, market research, and liaison work. As Circular 165 has been repealed and no mention of non-taxable activities has been made in the Circular, we must assume, unless a further circular is issued, that all activities of ROs will be taxable in the future. We understand that tax officials have had long-held concerns about RO’s false characterisation of activities to fall within the exception and this may explain why this practice is not continued in the Circular.

The Circular represents a fundamental shift in tax liability for ROs in China and all ROs need to determine how it affects them.