

Taxation on non-resident enterprises (Part 1)

1.1 Foreign company with permanent establishment

Some foreign companies have permanent establishment (PE) in China and some do not. Foreign companies are taxed on PRC source income whether or not they have any PE in China. Foreign source income is not taxable in general. But there is one exception. Where the foreign source income is effectively connected with the PE, the income is taxable in China. “Effectively connected” here means that the establishment owns equity interest or debt claim giving rise to income, or the establishment owns, manages, and controls properties giving rise to income.

	Foreign company with PE in China?	PRC source income	Foreign source income
1	Yes, if income is effectively connected with the PE	Taxable	Taxable
2	Yes, but income is not effectively connected with the PE	Taxable	Not taxable
3	No PE in China	Taxable	Not taxable

The following cases will give rise to a permanent establishment in China. First, the foreign company will be considered to have a PE in China if it has an establishment or a place of business in China. Second, the foreign company will be considered to have a PE in China if it has employees working in China for a certain period of time. Third, if the foreign company appoints an agent to conclude contracts or accept orders in China, it is considered to have a PE in China.

1.2 Establishment or place of business

Article 5 of the Detailed Implementation Regulations of the PRC CIT law provides that the following activities will constitute an establishment or place of business in China:

- (1) Management establishment, business establishment or an office;
- (2) Factory, farm, or place of extraction of natural resources;
- (3) Place where services are provided;
- (4) Place where a project of construction, installation, assembly, repair, exploration, etc is carried out;
- (5) Other establishments or places of business where production and business operations are carried out.

1.3 Taxation on permanent establishment

There are three main issues for the taxation of the permanent establishment: (i) the activities performed by the permanent establishment are **taxable** in general, but some of **the activities** are **not taxable**. For example, the purchase activities performed by the permanent establishment on behalf of the foreign company is not taxable; (ii) there is some relationship between the **domestic tax rules** and **treaty rules**. They are interacted with each other but also differ from each other in some respects. The PRC income tax law not only imposes tax on legal persons, but also on permanent establishments set up in China by non-residents. PE’s are subject to income tax on

business profits **as if they were legal persons**; and (iii) the income tax for the PE can be **computed either on the gross income or on the net income**. A comparison between the domestic tax rules and the treaty provisions may help illustrate the differences in the scope of taxable and non-taxable activities:

Item	Domestic income tax rules on PE	Exceptions: activities not constitute PE in treaty provisions
I	Establishment or fixed place of business in China	(i) The use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise; (ii) The maintenance of stock of goods or merchandise belonging to the enterprise solely for purpose of storage, display or delivery; (iii) The maintenance of stock of goods or merchandise belonging to the enterprise solely for purpose of processing by another enterprise; and (iv) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of advertising, or of collecting information for the enterprise. ¹
II	Presence of employees in China	(i) The provision of services by the employee on the other side does not constitute a PE if the duration of activities is not exceeding 6 months continuously or cumulatively in any 12-month period. ²
III	Agent in China to conclude contracts or accept orders	(i) The conclusion of contract does not give rise to a PE on the other side if the contract is concluded in connection with the tax-exempt activities as classified under item 1 above. ³

1.4 Legal form and bases of tax computation

Resident enterprises including foreign investment enterprise are taxed on net income. Foreign enterprises with PE in China are either taxed on gross income or on net income. One example of this is the commission earned by a representative office as trading agent. Normally the income the representative office made is ascertained by a deemed profit rate on the gross amount of the contract sum. It is because the information of the commission may not be available from the contracts. Where the representative office keeps full set of books recording all the income and expenses for the business activities in China, the tax authority may impose tax on a net income basis. Foreign enterprises that do not have any PE in China are taxed on gross income

¹ See Paragraph 4 of Article 5 of the DTA concluded between the PRC government and the government of Singapore, effective on 17th December 2007.

² See Paragraph 3 of Article 5 of the DTA concluded between the PRC government and the government of Singapore, effective on 17th December 2007.

³ See Paragraph 4 of Article 5 of the DTA concluded between the PRC government and the government of Singapore, effective on 17th December 2007.

in general. The types of income may take the form of dividend, interest and royalties that are paid from a resident enterprise in China to the recipients outside China.

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