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CHINA

Taxation of Representative Offices



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CHINA

Taxation of Representative Offices

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1. INTRODUCTION

Establishing a representative office (RO) enables a foreign investor to have a presence in China in a relatively short period of time without having to make any legal commitment to import capital into China. Furthermore, the fact that the RO's approval certificate is valid for a one-year period provides the foreign investor with a convenient exit option if the investor decides that it is not viable to establish a longer-term presence in China.

According to China's Income Tax Law for Foreign Investment Enterprise and Foreign Enterprise, and related Implementation Regulations, ministerial regulations and rules issued by the State Administration of Taxation (SAT), an RO that carries on taxable activities within China is subject to tax on income derived from sources in China irrespective of whether the income is paid by sources inside China.¹ Under the Chinese Business Tax Tentative Regulations, an RO that has engaged in taxable services is also subject to business tax.² In addition, under the Chinese Tax Levy and Administration Law (TLA Law), an RO is obliged to obtain a national tax number and comply with local registration requirements within 30 days of obtaining its business licence, and to file its business tax return and the income tax return in accordance with the tax laws and regulations.³ It should be noted that the requirement to register for a national tax number is mandatory even if the RO is subsequently granted a tax-exempt status.

The TLA Law also provides that the RO has a legal obligation to deduct from its payroll, the income tax and remit these amounts to the local tax office.⁴ In addition, the RO

and its employees have to make certain social security contributions toward pension funds and insurances for hospitalization, unemployment, occupational injury and birth planning, etc. According to the tentative provisions issued by the State Council, the RO has to appoint a designated Foreign Enterprise Services Company to handle the RO's payroll and social security administration.⁵

In addition to tax laws, many administrative regulations and rules are quoted as authorities and references in this article. Under the Chinese Legislation Law, the administrative body, which consists of the State Council, the Ministries, and the Institutions directly under the State Council (like the SAT), have the power within their respective jurisdictions to make legally binding rules that apply throughout the country, in descending order of authority.⁶ These will be collectively referred to as the Chinese tax rules hereafter for convenience sake.

2. ASCERTAINMENT OF TAXABLE INCOME

There are three methods to determine the taxable income of an RO, namely:

- the actual income method;
- the deemed income method; and
- the cost-plus method.

The decision on which of the above methods to use to report income, is not decided by the RO but by the supervising tax authority from which the RO needs to obtain approval.⁷

2.1. Actual income method

The differences among the above methods are that the actual income method follows the established accounting rules in order to ascertain the RO's taxable income. The actual income method imposes tax on the net income,

1. Art. 1 of the Income Tax Law for Foreign Investment Enterprises and Foreign Enterprises as promulgated by the National People's Congress (NPC) on 9 April 1991.

2. In a decision of the Standing Committee of the NPC effective on 29 December 1993, the Business Tax Tentative Regulation took effect on 1 January 1994 and has legal force on foreign enterprises including those that have established ROs in China. The original Consolidated Industrial and Commercial Tax Regulation promulgated by the State Council for trial implementation on 11 September 1958 was annulled on the same date.

3. The TLA Law as amended by the NPC in 2001. See Arts. 15 and 25.

4. The TLA Law as amended by the NPC in 2001. See Art. 30.

5. See Art. 11 of the Tentative Provision for the Administration of Resident Representative Offices, as issued by the State Council on 30 October 1980.

6. The Chinese Legislation Law, Arts. 56 and 71.

7. Circular (86) Cai Shui Wai Zi 055 issued jointly by the Ministry of Finance (MOF) and SAT on 3 March 1986.

which is based on the difference between the revenue and expense. The actual income method requires the RO to keep all information regarding contracts that have been concluded, commissions and rates, vouchers, and a complete set of accounts in accordance with China's accounting and tax rules. In addition, any expenses paid outside China have to be certified by a certified public accountant (CPA) in the place where such expenses are incurred.

2.2. Deemed income method

The deemed income method is revenue based. Under this method, the taxable income is equivalent to 3% of the gross income earned from taxable activities during a certain period.⁸ A typical example is the commission earned by an RO engaged in agency activities but information on the rate of commission is lacking in all or some of the agency contracts.

2.3. Cost-plus method

The third method is the cost-plus method that looks at the costs incurred by the RO in a certain period. For practical reasons, the tax authorities normally utilize the cost-plus method to ascertain the taxable income when they are unable to obtain complete and accurate information relating to an RO's Chinese sourced or non-Chinese sourced income.

Under the cost-plus method, the RO's monthly overheads, which consist of actual expenses incurred, are converted into revenue and then the amount is grossed up by a prescribed percentage. A 5% business tax, which is filed monthly, is then imposed on the total grossed-up amount of monthly overheads, while the 33% corporate income tax (CIT) is imposed on the deemed profit. It should be noted that the CIT rate of 33% includes a 3% local income tax.

The deemed profit is assessed at a rate of 10% on the total grossed-up amount of overheads incurred during the relevant period. The RO must file its income tax return on a quarterly basis. For example, if the monthly overheads are RMB 80,000, the business tax and CIT will be calculated as follows:⁹

gross amount = RMB 80,000 / (1 - 0.1 - 0.05) = RMB 94,118

business tax = RMB 94,118 x 5%

CIT = RMB 94,118 x 10% (deemed profit) x 33%

The CIT rate of 33% will be reduced to 15% if the RO is located within one of the five special economic zones (SEZs) or other designated areas. If a foreign company establishes more than one RO, each of the ROs will be required to file an income tax return using the tax rates applicable in that particular location.

2.4. Deductible expenses

The Chinese tax rules also specifically define what constitutes expenses that have been incurred. These include all wages and salaries, bonuses, allowances and welfare

received by the employees, irrespective of whether the payment is made inside or outside China. It also includes communication, travelling, rental, equipment leasing, transportation, entertainment expenses, and payments for the purchase of vehicles and office equipment, and other expenses.

All these payments must be evidenced by supporting vouchers. Expenses whose payments are made outside China, must be certified by a CPA in the home country of the RO's headquarters (HQ) and this certification must be presented to the local Chinese tax authority for verification.¹⁰ It should be noted that any overhead expenses incurred by the RO cannot be set off against any interest income received.¹¹

The following types of expenses paid on behalf of the non-resident HQ are excluded when ascertaining the RO's taxable bases:

- costs of air tickets for local persons to visit the HQ;
- travelling, entertainment and accommodation costs for HQ personnel paying a group visit to China. This does not include any expenses incurred for those personnel to conduct business negotiation and conclusion of contracts;
- costs incurred on exhibition participation, customs duty on samples, local transport, and other related expenses in connection with the HQ's participation in large exhibitions in China;¹²
- costs for renting conference venues to be used by the HQ for the purpose of organizing seminars. These seminars must not be related to business negotiation or conclusion of trading contracts;
- payments of registration fees in accordance with Chinese laws and advertising promotion fees paid to a third party in connection with sales of specified goods;
- compensation payments in relation to breach of contracts which had been previously concluded between the HQ and Chinese domestic entities; and
- payments of security deposits for imported equipment to be used by HQ staff in connection with the rendering of services within China;¹³ and
- any tax surcharge and fines imposed on the RO by the tax authorities.¹⁴

2.5. Tax treatment of assets

The Chinese tax rules also specifically provide alternative ways in which assets, such as vehicles, computers and equipment, are treated in calculating the amount of expenses. For assets other than furnishings, the RO can include the entire cost of such assets in its total expenses in the period such assets are purchased, or, alternatively, the RO may opt to allocate an appropriate amount over the

8. Circular (86) Cai Shui Wai Zi 273 issued by the MOF and SAT reduced the rate to 3% from 5%.

9. Circular (1985) Cai Shui Wai Zi 200 issued by the MOF and SAT, as revised by (1986) Cai Shui Zi Circular 290.

10. Circular (85) Cai Shui Wai Zi 200 issued by the SAT.

11. Circular Guo Shui Han Fa (1991) 1303 issued by the SAT.

12. Circular (88) Guo Shui Wai Zi 333 issued by the SAT.

13. Circular (89) Guo Shui Wai Zi 140 issued by the SAT.

14. Circular Guo Shui Han Fa (1991) 726 issued by the SAT.

minimum estimated life of the asset in accordance with the depreciation provision of the Chinese tax rules.

With regard to expenses incurred on furnishings, the RO may include the entire cost in the period in which such costs are incurred, or allocate such costs to its monthly overheads over a period of five years.¹⁵

Value added tax (VAT)

The RO has to bear VAT on tangible goods whether such goods are purchased in the domestic market or imported. If the assets are imported, then the RO will be liable to the customs duty and VAT (normally 17%) on the value of the imported assets. The VAT chargeable on a buyer who imports goods is arrived at as follows:

VAT amount = (composite dutiable value + import duty + consumption tax) × 17%¹⁶

If the assets or equipment in question are imported temporarily for exhibition purposes at the RO's office premises for a period not exceeding six months, then duty and taxes will not be payable. Instead, the RO is only required to place a refundable security deposit, at a designated bank, equal to the amount of the duty and taxes payable until such assets are finally shipped out of China.¹⁷

3. WHAT IS TAXABLE?

The SAT lists the following types of taxable activities that may be performed by an RO:¹⁸

- merchandise trade agent and/or advertising agent;
- providing consulting services relating to business, legal, tax and accounting matters;
- providing services to related subsidiaries;
- providing services relating to visa handling, fee collecting, ticketing, tour operator, and liaison for non-resident tourist companies;
- providing consulting services on behalf of non-resident financial institutions;
- providing services within the business scope of a transport company; and
- other taxable activities performed for clients.

The above activities are all related to the delivery of services inside China, which also fall within the definition of "taxable services" under the Chinese Business Tax Tentative Regulations. Accordingly, an RO that delivers any of the above-mentioned services will be subject to business tax.¹⁹ It should be noted that the liability to income and business taxes arises from the same source (i.e. the activities carried on by the RO), but the bases for these two taxes are different. Income taxes are imposed on income either on a gross basis or net basis depending on the method used, while the business tax is imposed on gross revenue.

The following activities are not subject to income and business taxes:²⁰

- resident ROs conducting market research services, providing business information, liaison and consult-

ing, and providing services to the non-resident HQ without a charge; and

- resident ROs taking instructions from resident companies and acting as an agent for the resident company, provided the agency activities are mainly performed outside China.

4. LEGAL RULES ON BUSINESS AND TAXABLE ACTIVITIES

In defining the activities that an RO may perform, the SAT has a number of different provisions²¹ that have been issued by the State Administration of Industry and Commerce (SAIC) and by the MOFTEC. Although it is the SAT who prescribes what constitutes a taxable activity,²² it is the SAIC that stipulates that an RO should be engaged in non-direct business activities subject to provisions of international agreements entered into by China.²³ These provisions shall later be discussed specifically. The MOFTEC also provides that ROs may only engage in non-direct business activities such as business liaison, product introduction, market research and technical exchange on behalf of their HQ.²⁴ Both the MOFTEC and SAIC, within the scope of their respective jurisdictions, prescribe what the RO can and cannot do, without addressing the issue from a tax perspective.

To determine whether certain activities are taxable, one has to consider the income tax rules rather than the functional role an RO is supposed to play within the organization as stated in the scope of its business licence. If the RO performs those non-direct activities for the client of its non-resident HQ or other non-resident foreign companies on a fee basis, then the income derived from those activities is still taxable under the Chinese income tax rules.

Table 1 may help analyse the points in the above paragraph.

15. Circular Guo Shui Fa (1998) 063 issued by the SAT.

16. The Chinese VAT Tentative Regulations, Art. 15.

17. Art. 25 of the Detailed Implementation Concerning the Approval and Administration of the Resident Representative Office set up by Foreign Enterprises, issued by the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) in February 1995.

18. Circular (165) issued by the SAT in 1996.

19. The Chinese Business Tax Tentative Regulations provides that all units and individuals engaged in the provision of services, as prescribed by the Business Tax Tentative Regulations, within China shall have the obligation to pay business tax, and shall pay business tax in accordance with the Business Tax Tentative Regulations.

20. Circular (85) Cai Shui Zi 110 issued by the MOF.

21. In the first session of the NPC held on 10 March 2003, a decision was passed to set up the Ministry of Commerce to replace the MOFTEC and State Economic and Trade Commission.

22. Circular 165 issued by the SAT in 1996.

23. Art. 3 of the Administration Method for the Registration of Representative Offices set up by Foreign Enterprises, issued by the SAIC and dated 15 March 1983.

24. Art. 4, Detailed Implementation Rules Concerning the Approval and Administration of Representative Offices set up by Foreign Enterprises, issued by the MOFTEC and dated 13 February 1995.

TABLE 1

	Scope of activities	Are the activities taxable?	Exceptions
Indirect business activities	Business liaison, product introduction, market research, and technical exchange.	Not taxable.	Taxable if they are performed, on a fee basis, for a third party, or client of the HQ, or other fellow subsidiaries within the same group.
Direct business activities	The types of taxable activities listed out as per SAT Circular 1996 (165).	Taxable.	(1) Subject to provisions in DTAs China has entered into; or (2) Performing agency activity outside China on behalf of resident principles.

ROs that do not carry on business activities or carry on non-taxable activities, can submit applications to the tax authority for the granting of income tax and business tax exemption certificates. However, the exemption does not apply to the income earned by the employees of the RO including the chief representative. If the RO has been granted an income-tax-exempted status, the Chinese tax rules deem the employees to have individual income tax liabilities in China. Whether or not the salaries are actually charged to or borne by the RO, the individual employees will be subject to Chinese income tax. Similarly, where the deemed income method is used to tax the RO, the Chinese tax rules deem salaries of the employees as either being charged to or borne by the RO.²⁵ Please note that under either of the above two situations, the RO has the withholding obligation with regard to the employees' individual income tax liabilities. The Chinese tax rules specifically provide that the determination of the income tax liability for the RO's staff, who are not Chinese citizens, is independent of the issue of whether the RO is exempted from income taxes.²⁶

5. INTERNATIONAL AND BILATERAL AGREEMENTS

The international agreements China has acceded to may have provisions that differ from the domestic laws and regulations in respect of the scope of business activities. Under Chinese law, these international agreements should take precedence in the event of a conflict or inconsistency.

China has pledged to liberalize the services sector as part of its commitment when acceding to the World Trade Organization (WTO) in 2001. Specifically foreign investors are to be allowed to establish ROs in China to engage, to a limited extent, in profit-making activities in

the field of legal, accounting and tax practices, and management consulting.²⁷

In the double tax agreements (DTAs) entered into by the Chinese government, the provisions for taxable and non-taxable activities may be identical with the Chinese domestic tax rules in some areas, but they may also be different from the domestic tax rules in other areas. Where there is an inconsistency, the provisions of the DTAs should take precedence. In the DTAs that China has entered into with Australia, Japan, Singapore, the United Kingdom (UK) and the United States, the following activities, performed by an RO, are classified as either taxable or non-taxable:

TABLE 2

	Types of activities	Exceptions
Non-taxable activities	(1) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise; (2) The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activities of a preparatory or auxiliary character; (3) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery.	The activities should be restricted to that performed for the enterprise itself. If done for third party enterprises or other enterprises within the same group, the said activities are taxable.
Taxable activities	(4) The staff of the RO has authority to conclude contracts in the name of the enterprise within China (or the DTA partner country); (5) The staff of the RO regularly secures orders in China (or its DTA partner country) wholly or almost wholly for the enterprise itself, and other enterprises which are controlled by that enterprise. (Note that this provision only appears in the DTA with Japan.)	If the conclusion of contracts (but not the accepting of orders) is related to the activities as mentioned in points (1) to (3) above, it will be exempted from tax liabilities.

5.1. Application of DTA rules

The DTAs operate to ensure the elimination of double taxation arising therein, i.e. that the same income will not be subject to tax again in the home country. The DTAs also operate to allocate the taxing jurisdiction between the countries when the resident of one country has activities in the other country, for instance in the form of a permanent

25. Circular 148 (1994) issued by the SAT on 30 June 1994.

26. Circular Guo Shui Fa (1999) 607 issued by the SAT. See Para. 2.

27. See Part II – schedule of specific commitments on services in Appendix 9 of the Protocol on China's accession to the WTO.

establishment (PE). The DTAs also provide how certain types of income are to be taxed.²⁸

In respect of the allocation of taxing rights, the DTAs follow the principle that the taxing right rests with the host country where the activities from which such income arises are performed, while the home country surrenders its right to tax. In this respect, the taxing right of the home country is restricted. These taxing rights are also restricted in the host country under certain circumstances. For example, the activities solely performed by the RO in relation to the purchase of goods or merchandise inside China for its non-resident HQ are not taxable under the DTA provision.²⁹ That is a specific restriction to a general restriction in the DTA provisions.

In respect of how the income is taxed, the DTAs provide that only the income that is attributable to the PE may be taxable in the host country. Here the discretion is left to the host country. The Chinese tax rules confirm that a foreign company that has set up an RO in China is considered to

have a PE situated inside China.³⁰ The Chinese domestic tax rules lay down what is taxable and what is not as discussed earlier.

Finally, the personal scope of a DTA is limited to the persons who are residents of the country with which China has entered into a DTA and does not apply to an RO established by persons who are not the residents of that country. The scope of the taxes covered in the DTA is restricted to income taxes only and does not include the business tax.

28. Art. 7 of the China-UK DTA provides that, "The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to the permanent establishment."

29. Art. 7 also provides that "No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise".

30. Circular Guo Shui Fa (1999) 607 issued by the SAT.