News Flash

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Changes to Tax Rules for Foreign Companies Deriving Income through Establishments in China

Under China's Corporate Income Tax ("CIT") regime, if a non-tax resident enterprise ("Non-TRE") has an establishment or place of business (collectively called "Establishment") in China, it would be subject to CIT in respect of the income derived by such Establishment. If the Non-TRE is a tax resident of a jurisdiction which has entered into a double tax agreement ("DTA") with China, it may be able to claim exemption from CIT if its Establishment does not constitute a permanent establishment ("PE") in China pursuant to the PE article under the relevant DTA, i.e. treaty protection.

In practice, the Chinese tax authorities and Non-TREs have been following the principles set out in a few tax circulars issued by the China State Administration of Taxation ("SAT") under the former Foreign Enterprise Income Tax ("FEIT") regime to determine the taxable income attributable to their Establishments in China. Technically, these old circulars are no longer valid under the CIT regime after 2007, but they have to rely on them because so far there have been no clear tax policies to the same effect under the CIT regime.

On 20 February 2010, the SAT released a tax circular Guoshuifa [2010] No.19 ("Circular 19") entitled "the Administrative Measures for the Collection of Corporate Income Tax on Non-tax Resident Enterprises on a Deemed Basis", to clarify how to determine the taxable income attributable to the Non-TREs' Establishments in China. On one hand, this circular is basically to lay a foundation of the CIT policies in this aspect. On the other hand, it also brings about some critical changes, rather than simply a repetition of the old rules.

In this Issue of News Flash, we would highlight the salient points of Circular 19 and share our observations and suggestions in relation to Non-TREs' Establishments in China.

Salient points of Circular 19

Computation basis

For computing the CIT taxable income of the Non-TREs, they are required to maintain accurate and complete accounts to determine the actual profits arising from the Establishments in China (the so called "actual profit basis") which are commensurate with the functions and risks of the Establishments in China.

If a Non-TRE is unable to correctly compute taxable income due to inaccurate or incomplete accounts or other reasons, the Chinese tax authorities shall assess the taxable income using one of the following "deemed profit methods":

Deemed profit method	**Applicable situation**	**Formula to compute taxable income**
"Actual revenue and deemed profit"	Where revenue can be ascertained but costs and expenditures cannot be	Taxable income = revenue x deemed profit rate
"Cost-plus"	Where revenue cannot be ascertained but costs can be	Taxable income = Cost/(1-deemed profit rate) x deemed profit rate
"Expenditure-plus"	Where revenue and costs cannot be ascertained but expenditures can be	Taxable income = expenditures/(1 – deemed profit rate – business tax rate) x deemed profit rate

It appears that the "Cost-plus" method should be used for a trading or manufacturing Establishment, while the "Expenditure-plus" method for a servicing Establishment.

Deemed profit rates

Circular 19 sets forth the range of deemed profit rates to be applied under the "deemed profit methods" for different types of businesses and they are, on an average, 5%-20% percentage points higher than those under the former FEIT regime. Provided below is the comparison.

Industry	**CIT regime (Circular 19)**	**FEIT regime**
Construction projects, designing and consulting services	15% - 30%	• No less than 10% (for construction projects) • 15% (for designing service)
Management services	30% - 50%	20% - 40%
Other operating and service income	No less than 15%[1]	10%

The Chinese tax bureaus at provincial level are allowed to determine the range of deemed profit rates to be used in their regions in accordance with the above prescribed ranges.

Circular 19 further provides that if the tax bureaus have evidence to believe that the actual profit rate of the Establishment of a Non-TRE should be significantly higher than the above range, it can use a deemed profit rate higher than the range in deeming the taxable income of that Non-TRE. Hence, there could be no upper limit effectively.

Income from after-sale services of equipment

According to Circular 19, where a Non-TRE sells equipment and at the same time provides after-sale services (such as, installation, technical training, supervision, etc.) in China, the Chinese tax bureau shall assess the service income by reference to pricing standard in the same or similar service sector in case where the service fee is not specified in the sales contract or not charged on a reasonable basis. Where reference is not available, the tax bureau may apportion the contract amount to be the service income and the proportion shall not be less than 10% of total contract amount.

There was a similar policy in the former FEIT regime but the minimum acceptable apportionment rate for deeming service income was only 5%.

Allocation of onshore vs. offshore service income

[1] The deemed profit rate of 5% for Non-TREs deriving income from international transportation services in China is covered under a separate tax circular Guoshuihan [2008] No.952.

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Non-TRE service providers are subject to CIT for service fees relating to services rendered in China but not for offshore services. Circular 19 reiterates the basic sourcing rule of "where the services are rendered".

In the former FEIT regime, there was a tax circular[2] requiring that, for a consulting service project for a Chinese customer where services are rendered both in and outside China, at least 60% of the contract amount should be allocated as the services rendered in China ("onshore service income") notwithstanding that the actual onshore services could be less than such ratio. Such compulsory allocation ratio is no longer mentioned under Circular 19.

Further, Circular 19 stipulates that where the Chinese tax bureau casts doubt on the reasonableness and truthfulness of the onshore and offshore service income allocation, they can request the Non-TREs to provide evidence to substantiate the allocation. Where they think fit, they may re-allocate the onshore and offshore service income by reference to work volume, time, cost, and other relevant factors. In extreme cases where the Non-TRE is not able to provide the evidence, the entire service income may be deemed as onshore service income, and subject to CIT.

PwC Observations

Rationale and motivation for the changes

As noted above, there are some critical changes in the tax policy for Non-TREs in this aspect. Based on our observations, we believe that the SAT has the following rationale and motivation behind such changes.

Prima facie, the increase in deemed profit rates seem to serve as a means to raise tax revenues for China. However, it is not the main purpose of the SAT.

In the past, most Non-TREs adopted the deemed profit methods to compute FEIT/CIT on income derived by their Establishments in China as it was easier to adopt, agree, and file with their local-level tax bureaus. Also, the Non-TREs did not need to disclose too much information to the local-level tax bureaus in the process of reporting. More importantly, it was at times more beneficial where they were able to secure a deemed profit rate lower than their actual profit rates.

The SAT has realised this potential tax loophole and attempts to restore the accuracy of the CIT taxable income for Non-TREs in such situations. The SAT tries to de-motivate these Non-TREs from using the deemed profit methods and switch to the "actual profit basis" to compute the CIT taxable income by way of heightening the range of the deemed profit rates as reflected in Circular 19.

For the same token, the 60%/40% compulsory allocation ratio under the former FEIT regime for consulting services income appeared to be helpful to secure more tax revenues. However, such arbitrary ratio also resulted in inaccurate FEIT taxable income for Non-TREs, either more or less.

Now, the SAT puts its focus back to basic. It requires Non-TREs to correctly keep accurate and complete account books as a good basis to determine the actual profits which are consummate with the functions and risks of the Non-TREs' Establishments in China. Doubtless, this is in line with the OECD guidelines and international practices for determining the profits of a non-resident attributable to a PE in another jurisdiction.

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[2] The former tax circular was Guoshuifa [2000] No.82

However, it is still unclear why Circular 19 leaves it to the Non-TREs to state and substantiate that they do not have complete or accurate accounts or other reasons disabling the actual profit basis adoption, and to pick the deemed profit method; and then ask the local-level tax bureaus to assess the appropriateness of adopting deemed basis and the reasonableness of the chosen deemed profit rate.

Implications to Non-TREs and tax administration

Such changes in the tax policy would inevitably cause concerns to the Non-TREs as well as Chinese local-level tax bureaus. The following are some:

- There could be practical difficulties to apply the “actual profit basis”. From the perspective of the Non-TREs, it is not easy to correctly allocate the expenses incurred on each project, especially if a Non-TRE carries out several projects in China simultaneously. More difficulties would arise if the service is partially rendered in China and partially outside China, and the expenses have to be separately allocated to the onshore and offshore portion. This also poses practical difficulties to the Chinese local-level tax bureaus on how to verify the expenses allocated from overseas, how to ensure that the expenses allocated between onshore and offshore portion is reasonable, etc.

- Circular 19 highlights the reference of the functions and risks of the Establishments in China for computing the taxable income on “actual profit basis”. This sounds theoretically correct. However, it may result in more administrative burdens to the Non-TREs as they have to prepare and maintain all the information, analysis, and documentation to justify that the profits reported on actual basis for an Establishment truly reflects the functions and risks undertaken. It also remains to be seen whether the Chinese local-level tax bureaus have enough resources and technical knowledge to review and examine the positions reported by the Non-TREs.

- As noted above, the range of deemed profit rates have been increased. So, where a Non-TRE continues to adopt the deemed profit method as before Circular 19, it would be subject to a higher tax cost in China (also pending whether it could be eligible for foreign tax credit at its home (foreign) jurisdiction).

- Not only heightening the deemed profit rates, Circular 19 even allows the local-level tax bureaus to apply an even higher rate if they have “evidence” to believe that the actual profit rate of the Establishment of a Non-TRE is significantly higher than the specified ranges. It gives rise to concerns about what are those kind of so-called “evidence”, and how the local-level tax bureaus use it in their assessing practice.

- The removal of the 60%/40% compulsory allocation is a good news to Non-TREs which undertake consulting services both in and outside China. They are now allowed to allocate the service income based on the actual basis. Of course, it is important that they are able to produce and maintain sufficient evidence to substantiate the lower ratio of onshore service. On the other hand, it still needs to wait and see whether the local-level tax bureaus would simply accept such change, or they would still insist to apply the same compulsory allocation ratio as they believe it is much simple in their administration.

Other observations

- Circular 19 does not address Business Tax (“BT”) treatment for income derived by Non-TREs from their Establishments in China. We believe there is no change in the BT rules. In particular, with the new

development of BT under the Amended BT Regulations effective 1 January 2009, the source rule of BT has changed from "location-related" to "party-related" (with the short grace period).

- Circular 19 has taken effect from its issuance date on 20 February 2010. It does not address the transitional treatments for those on-going service projects commencing before but not yet completed by 20 February 2010. We believe that if there is no further clarification from the SAT, it would largely depend on the positions of the local-level tax bureaus

Our suggestions

The changes in the tax treatments brought about by Circular 19, particularly with respect to the increased deemed profit rates and allocation of onshore/offshore income, would have immediate and significant impact on Non-TREs' tax costs and accordingly their bottom line of the projects in China. Some of the actions that can be taken at this stage may include:

- Revisit the tax filing basis, deemed profit rate and the onshore/offshore allocation for the on-going projects in China;
- Analyse the possible impact of Circular 19 on the on-going and potential projects to the bottom line;
- Study the functions and risks of the projects;
- Compare the tax and administrative costs under the "actual profit basis" and the "deemed profit methods" and plan for the future projects;
- Discuss with and seek confirmation from the local-level tax bureau in-charge of the current projects on whether the current tax filing basis can remain status quo.

Circular 19 is newly issued. It is still uncertain about the response of the local-level tax bureaus. We will closely monitor the development on this subject and share with you our observations and insights, when available.