

# Tax Analysis

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## PRC Tax

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### [More guidance on calculation of tax for nonresident establishments](#)

The State Administration of Taxation (SAT) issued two circulars on 20 February 2010 (Guoshuifa [2010] No. 19 (Circular 19) and Guoshuifa [2010] No. 18 (Circular 18)) that provide guidance on the calculation of Chinese Enterprise Income Tax (EIT) by nonresident companies with establishments in China.

Circular 19 is applicable to nonresidents as stipulated in paragraph 2 of article 3 of the EIT Law, i.e. nonresident companies that derive China-source income from their establishments in China and non-China-sourced income that is effectively connected with the establishments in China. Although the scope of Circular 19 extends to Chinese representative offices of nonresident companies, Circular 18 should be referred to in determining the tax base of representative offices (RO), which provides detailed and specific regulations on the calculation of tax of a representative office (see Tax Analysis (P101/2010) – "New rules issued on taxation of foreign company's representative office in China" for further details on Circular 18).

These two circulars, taken together with various previous circulars addressing the tax treatment of nonresident companies, indicate the continued focus and intent of the SAT to enforce the administration of nonresident companies. More regulations are expected to be issued during the course of 2010. Circular 19 takes effect on 20 February 2010.

### Highlights of Circular 19

#### 1. Function and risk alignment

Before Circular 19, it was unclear whether an establishment was required to recognize income based on its functions and risks. Circular 19 specifies that, regardless of whether an establishment of a nonresident company is taxed on an actual basis or a deemed method, taxable income should be commensurate with the functions and risks undertaken by establishment. This appears to indicate that China is adopting the authorized OECD approach, (AOA) which hypothesizes a permanent establishment (PE) as a distinct and separate enterprise in analyzing the functions and risks undertaken by the PE, and then determines the profits of the PE based upon a comparability analysis. To implement the AOA approach in situations where a nonresident company has an establishment in China, further guidance would be needed from the tax authority, e.g., whether and how the existing transfer pricing regulations would be applicable to the establishment of a nonresident company.

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## 2. Tax method

Circular 19 provides that nonresident companies that have an establishment in China should maintain adequate accounting books and records and that these records will form the basis for filing the EIT returns. However, if a nonresident company is unable to accurately calculate and file its taxable income because of incomplete accounting books, is unable to check its accounts because of a lack of information or for any other reasons, the tax authorities are entitled to assess taxable income using one of the following methods:

Method 1 – Deemed profit based on revenue: This method is used if the taxpayer can accurately calculate its revenue or gross income but cannot calculate its costs and expenses.

*Taxable income = gross revenue x deemed profit rate*

Method 2 – Deemed profit based on costs and expenses: This method is used where the taxpayer can accurately calculate its costs and expenses but cannot accurately calculate gross revenue.

Although not specified in Circular 19, this method generally should be applicable to establishments engaging in profit-generating activities that require cost/expense allocation for accounting purposes, such as activities involve manufacturing, the sale of goods, construction projects, etc.

*Taxable income = total costs and expenses / (1 – deemed profit rate) x deemed profit rate*

Method 3 – Deemed profit based on expenses: This method is used where the taxpayer can accurately calculate its total expenditure but not its total revenue or costs and expenses.

Although not specified in Circular 19, this method is generally understood to be applicable to establishments engaging in activities that do not require cost/expense accounting, but that usually only incur expenses (typically ROs, cost centres, etc.). As Business Tax would not be part of the expenses, the Business Tax should be considered for the gross-up.

*Taxable income = total expenses / (1 – deemed profit rate – business tax rate) x deemed profit rate*

## 3. Deemed profit rate

Profit rates are set out for various categories of activities but the exact rate may depend on the locality because Circular 19 grants discretion to the local tax authorities as to how to apply the ranges. The ranges are as follows:

- Projects for the provision of construction, design and consulting services: 15%-30%
- Provision of management services: 30%-50%
- Provision of other services or operations other than services: no less than 15%

Circular 19 also states that the in-charge tax authorities can adopt a higher profit rate if they consider that the actual profit margin is significantly higher than the ranges provided. If a taxpayer considers the above deemed profit rates to be high, it would prefer to be taxed on an actual basis, and accordingly would be more likely to maintain complete and accurate books. As a result, the use of the deemed profit method may eventually taper off in practice.

#### 4. Mixed activities

Circular 19 sets out the tax treatment of contracts involving mixed activities (i.e. contracts involving the sale of goods and services and contracts involving services that are subject to different deemed profit rates) as well as contracts involving services carried out within and outside China.

**Mixed contracts:** Where one contract involves the provision of goods and services, particularly those relating to the sale of machinery, equipment or other goods and after-sales services (such as installation, assembly, training, supervision, etc.), the contract should clearly stipulate and allocate the income attributable to the sale of goods and the provision of services. If an allocation is unclear, the tax authorities reserve the right to deem the amount of services income by applying the portion that would apply in similar contracts/industries or deem the services income to be no less than 10% of the contract value.

If a contract involves the provision of two or more services where different deemed profit rates apply, income must be calculated separately; otherwise, the tax authorities will apply the highest applicable deemed profit rate.

**Onshore and offshore contracts:** Where services are provided both within and outside China, onshore and offshore service income will be allocated according to where the services were performed. If this allocation is not made or the tax authorities question the rationale and authenticity of a claim, information will be required to support the proposed allocation. If adequate information cannot be provided or is insufficient to justify the claim, the tax authorities may deem 100% of the services to have been performed within China.

#### 5. Administration

Taxpayers that choose to apply a deemed taxation method must complete the tax method assessment form and submit it to the competent tax authorities for approval. Circular 19 does not provide a timeframe for submission of the form, but it does require the tax authorities to issue notice to the taxpayer within 15 days of receipt of the assessment form if the authorities do not accept the method adopted by the taxpayer. If the taxpayer does not receive any notice from the tax authorities within the 15-day period, the authorities are presumed to agree with the method applied by the taxpayer.

#### Comments and recommendations

Nonresident entities with establishments or ROs in China typically have applied a deemed taxation method and Circular 19 adopts the similar methods that have been used in the past. However, the deemed profit rates have substantially increased as compared to previous rates used by the tax authorities. The effect of these changes, including the uncertainty as to whether a deduction will be available for expenses reimbursed, could have significant implications for nonresident establishments.

Income category	Previous rules	Circular 19
Contracted construction, design and consulting contracts	At least 10% (15% for design services) - deduction available for reimbursement of equipment/material	15%-30% - Silent on whether reimbursements may be deducted
Management services	20%-40%	30%-50%
Other services and operations	No specific rule	At least 15%

Following on from other recent tax circulars, Circular 19 emphasizes the need for taxpayers to have sufficient documentation to support their filing positions, particularly for contracts involving the sale of goods and services or where the services are performed both onshore and offshore. Taken in this context, Circular 19 should serve as another alert to taxpayers that the tax authorities will closely review the tax calculations of nonresident companies and documentation will be crucial to support all filing positions.

In light of the above, nonresident companies with establishments in China should consider taking the following actions:

- Review the current filing status to determine whether an actual basis or a deemed method would be appropriate, taking into account the activities and accounting status of the establishment;
- If a deemed method is appropriate, select the appropriate method and assess the tax impact;
- Review the function and risks of the establishment and understand whether there is potential risk of any challenge by the tax authorities;
- Carefully review the terms of current or proposed contracts/invoices to ensure that income is specifically allocated to particular goods or services so that the correct deemed profit rates are determined;
- Ensure that internal documentation is in place to help substantiate and support onshore versus offshore claims, including travel logs, timesheets and expenses incurred;
- Consult with the competent tax authorities for local filing requirements and file the appropriate tax method assessment form in a timely manner to avoid late payment penalties.

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