



China tax law commentary

中国税务评论



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11:00 a.m. EST December
10, 2009 hosted by Wendy
Cai

In this update

This update highlights recent guidance issued by the Chinese State Administration of Taxation (SAT) that is designed to strengthen the tax authorities' tax collection and administration and how this guidance can affect companies doing business in China.

In the first half of 2009, the entire tax revenue generated by the nation was approximately RMB 2,953 billion, reduced by about RMB 189.5 billion compared to the same period in 2008, which represents a 6% reduction in tax revenue. To cover this substantial revenue shortfall, the SAT has issued a series of circulars to improve tax collection and administration.

These circulars include:

- Circular 103 (Ji Bian Han [2009] No. 103), issued July 2, 2009, entitled "Investigation of the Enterprise Income Tax Collection of Expatriates Providing Services to Domestic Enterprises," which intensifies the scrutiny of secondment arrangements by non-PRC tax residents (e.g., MNCs) with their Chinese affiliates. The SAT requires local tax authorities to reassess the PRC tax implications of MNCs that have assigned expatriates to management, technical support, or other key positions in their Chinese affiliates. If the secondment arrangement is deemed to have created a permanent establishment (PE), the MNC will be required to pay 5% business tax and 25% corporate income tax in China on profits attributed to the PE.
- In the past, secondment arrangements were an effective method to avoiding PE exposure for MNCs sending employees to China for an extended period of time. It was widely accepted by the Chinese tax authorities that MNCs were not providing services by having secondees assigned to their China affiliates if the secondees were under the control and direction of local management. Circular 103 does not give any indication as to how a secondment arrangement can be distinguished from the provision of services; the SAT, however, is expected to provide further guidance on this issue. For a more detailed discussion of Circular 103, please see our China tax analysis at: http://www.deloitte.com/dtt/cda/doc/content/cn_tax_tap812009eng_270709.pdf

http://www.deloitte.com/dtt/cda/doc/content/cn_tax_tap832009eng_050809.pdf

- Circular 363 (Guo Shui Han [2009] No. 363), issued July 6, 2009, on “Strengthening the Supervision and Investigation of Cross-Border Related Party Transactions,” imposes documentation requirements on certain single-function entities (SFEs). SFEs, including but not limited to toll and contract manufacturers, distributors, and contract R&D service providers are required to prepare transfer pricing documentation for years in which they incur losses and to submit relevant documents to the tax authorities before June 20 following the end of the calendar year, regardless of the volume of transactions (even if the transactions otherwise would have fallen outside the scope of the documentation requirement under the original transfer pricing safe harbor rules). For the 2008 calendar year, we understand from discussions with the SAT, that the due date is December 31, 2009. For a more detailed discussion of Circular 363, please see our China tax analysis at: http://www.deloitte.com/dtt/cda/doc/content/cn_tax_tap822009eng_290709.pdf
- Circular 114 (Guo Shui Fa [2009] No. 114), issued July 27, 2009, on “Several Measures to Further Strengthen Tax Collection and Administration,” provides guidance to the local tax authorities with a view to enhancing the tax administration of nonresidents and preventing tax avoidance. Compared with other special purposes tax audits, Circular 114 increases the focus of tax audits on nonresident related-party transactions and national and cross-region cooperation in such audits. For a more detailed discussion of this circular, please see our China tax analysis at: http://www.deloitte.com/assets/Dcom-China/Local%20Assets/Documents/Services/Tax/Tax%20Newsletter%202009/cn_tax_TAP842009eng_010909.pdf
- Circular 124 (Guoshuifa [2009] No. 124), issued August 24, 2009, on “Administrative Measures on the Tax Treaty Treatment of Nonresidents,” clarifies the procedures and documentation requirements for nonresidents wishing to obtain benefits under China’s income tax treaties. Unlike in the U.S., formal approval is required for a nonresident to obtain reduced withholding tax rates under a treaty for China-source passive income, such as dividends, interest, royalties, and capital gains. Once approval is obtained, it is valid for three years with respect to recurring items of income. MNCs claiming treaty protection in connection with PEs, business profits, dependent and independent personal services, and other tax treaty relief (except for income that requires approval) must file prescribed reports with the in-charge tax authorities. The approval procedures and filing requirements are substantial and extensive in nature and will result in additional compliance and administrative burdens. The circular is effective as from October 1, 2009. For a more detailed discussion of this circular, please see our China tax analysis at: http://www.deloitte.com/assets/Dcom-China/Local%20Assets/Documents/Services/Tax/TaxNewsletterEN2009/cn_tax_tap872009eng_180909.pdf

Impact on U.S. MNCs

The flurry of circulars issued in the last few months demonstrates the Chinese tax authorities are under pressure to conduct tax audits and otherwise increase tax revenue by attributing profit to PEs, limiting losses and increasing obstacles to obtaining treaty benefits. In addition to the impact on cash flow, the impact of the new policies on U.S. MNCs is extensive, since the new U.S. Accounting Standard Codification 740 (ASC 740, the equivalent of FIN48) effectively requires that both private and public companies account for uncertain tax positions.

Most companies that invest in China have some expatriate employees working or traveling in China. With the uncertainty about potential PE exposure, it would be difficult for companies to quantify and make necessary tax provisions. Despite the clear business benefits of lower costs and the vast market potential in China, the complexities of doing business in the country cannot be ignored. U.S. MNCs should consider the following actions in response to the above developments:

- Review existing secondment arrangements and ensure that appropriate documentation on the responsibility and authority of expatriates matches the current tax position.
- Review service contracts with existing related Chinese affiliates and determine whether the Chinese subsidiary is performing a single function and whether it has any current- and prior year losses. If transfer pricing documentation is required, it should be prepared by December 31, 2009. This represents a substantial change in the prior safe harbor rules, so even companies that previously did not think they were required to prepare transfer pricing documentation should rereview their position.
- If an audit request or audit adjustment is received from the local tax authorities, please call your advisor for assistance to avoid locking in positions that could potentially be contradictory for other tax items, such as VAT and business tax.
- Consider compiling approval documents for claiming tax treaty benefits under the U.S.-China treaty even before an actual dividend is declared. Since the approval process can be protracted and once approval is obtained, it is valid for three years, MNCs could optimize cash flow by starting the approval or filing process early.
- U.S. private companies, including pass-through entities, such as partnerships and nonprofit entities, should consider the impact of all of the circulars on ASC 740 by reference to Accounting Standards Update (ASU) 2009-6. Many private equity funds, venture capital funds, and private companies that did not have to deal with uncertain tax positions under the old FIN 48 rules now will have to spend more time to understand the overall implications of the SAT's guidance.
- U.S. public companies that previously assessed the China-related FIN48 implications will need to reassess the impact of the new circulars under ASC740. For example, a "more-likely-than-not" position maybe changed under these circulars.

Since the only constant in China is change, we will continue to monitor developments and endeavor to bring the latest news to your attention. Please feel free to contact our

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