

AN ALERT FROM THE BDO INTERNATIONAL TAX PRACTICE

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INTERNATIONAL TAXATION



► SUBJECT

CHINESE TAX AUTHORITY TARGETS FOREIGN BUSINESSES IN CHINA

► ISSUE

On February 20, 2010 the Chinese State Administration of Taxation ("SAT") issued Guoshuifa [2010] No. 19 ("Circular 19"), which provides new guidelines for the application of deemed profit methods to calculate the enterprise income tax ("EIT") for nonresident enterprises.

► AFFECTING

Foreign companies that conduct certain business activities in China, such as the provision of construction, design, consulting, management, and other services.

► DETAILS

Circular 19 states that a nonresident enterprise defined under the EIT Law is required to set up accounting books in accordance with China's Tax Collection and Administration Law and other relevant laws and regulations; to proceed with accounting treatment using legitimate and valid vouchers; to accurately calculate its taxable income based on the matching principle of its functions and risks; and to report and pay EIT on an actual profit basis. If an enterprise presents incomplete accounting books or documents resulting in difficulty in performing a tax audit or cannot correctly calculate and report the EIT on an actual profit basis for any other reason, the SAT reserves the right to use a deemed profit method to determine the taxable income of the nonresident enterprise. ►Read more

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The deemed profit methods under Circular 19 include a gross income method, cost-plus method, and expenditure-plus method. The determination of which of the methods to apply is based on the following conditions:

Methods	Application Conditions	Formulas
Gross income method	A nonresident enterprise can accurately compute its gross income or deduct its gross income using reasonable methods but cannot accurately compute its costs and expenses.	Taxable income = gross income x profit rate determined by the tax authorities
Cost-plus method	A nonresident enterprise can accurately compute its costs and expenses but cannot accurately calculate its gross income.	Taxable income = total cost and expenses divided by (100 percent - profit rate determined by the tax authorities) x profit rate determined by the tax authorities
Expenditure-plus method	A nonresident enterprise can accurately compute its operating expenses but cannot accurately calculate its gross income and costs and expenses.	Taxable income = total operating expenses divided by (100 percent - profit rate determined by the tax authorities - business tax rate) x profit rate determined by the tax authorities

The profit rates under these methods fall within the following framework, according to Circular 19:

- 15 to 30 percent for construction projects and design and consulting services;
- 30 to 50 percent for management services; and
- 15 percent or more for other services or any business activities other than services.

A higher rate, however, can be used if the tax authorities, with evidentiary support, believe that the actual profit rate of a nonresident enterprise obviously exceeds the above standard.

Representative offices set up by foreign companies in China could be subject to the application of deemed profit methods to the EIT at a deemed profit rate of 15 percent or more if they cannot accurately compute their gross income, costs, or expenses, or cannot file the EIT on an actual profit basis in accordance with relevant provisions, according to Guoshuifa [2010] No. 18 ("Circular 18"), also issued by the SAT on February 20, 2010.

Cross-border services rendered by a nonresident enterprise are subject to a sourcing principle for EIT purposes, under which income derived from service activities taking place in China will be subject to the EIT. The Chinese tax authorities, however, may ask a nonresident enterprise to submit authentic, valid supporting documents and may reasonably determine the Chinese and foreign-source income for the services based on the volume and time of work, costs and expenses, and other factors. If the nonresident enterprise cannot submit authentic, valid supporting documents, the tax authorities can regard all of the services as arising in China under Circular 19.

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▶ COMMENTS

Foreign companies doing business in China are not subject to the EIT if their business activities do not establish a permanent establishment in China according to applicable tax treaties. However, many foreign companies could not avoid establishing a permanent establishment in many cases because of business requirements and therefore are likely to be subject to the EIT.

If a nonresident enterprise cannot maintain complete Chinese accounting books or accurately calculate Chinese taxable income, it may result in the application of the deemed profit methods to the EIT at deemed profit rates ranging from 15 percent to 50 percent (depending on the business activity) or greater, which increases their Chinese tax burden and risks. Before Circulars 18 and 19 were released, a deemed profit rate of ten percent, which was provided to calculate the EIT of foreign companies' representative offices when using deemed profit methods, was also commonly used for other nonresident enterprises in cross-border construction, design, consulting, management, and other services because of a lack of transparent guidelines.

Transfer pricing issues may be triggered if nonresident enterprises perform taxable related-party transactions that are not at arm's length. Circular 19 provides that the tax authorities can make adjustments to nonresident enterprises' taxable income (which has been computed and reported) using deemed profit methods if the taxable income is incorrect or apparently does not match the functional risks assumed by the nonresident enterprises. Those deemed profit rates specified in Circular 19 should not necessarily be treated as statutory or acceptable profit rates for all transfer pricing compliance practice because they are designed only to compute the taxable income of nonresident enterprises under the deemed profit methods, according to the new guidelines.

Some tax strategies and structures applied by foreign companies may be challenged or become inefficient or inapplicable because of the changes in the Chinese tax laws. Foreign companies are advised to monitor new tax developments and adjust their tax strategies and structures accordingly to keep their Chinese tax burden and risks minimized.

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