Whither will representative offices in China go?

Clement Yuen and George Lam discuss the growing administrative and tax challenges facing representative offices in China

Setting up a representative office has been a common way for foreign investors to open businesses in China. A representative office often serves as an initial establishment for foreign investors to gain a better understanding of the local market before they make bigger investments in the form of joint ventures or wholly foreign-owned enterprises.

Many multinational companies find a representative office flexible because of its simple application and registration procedures (it is not considered a separate legal entity from the foreign enterprise), less stringent regulatory compliance, zero registered capital requirement and relatively predictable tax costs. However, representative offices have come under scrutiny because companies have been using them to conduct active business activities in China, employing hundreds of workers and earning profits.

In August 2008, the Legislative Affairs Office of the State Council released a consultation draft to revise and update Measures for Administration of Registration of Representative Offices of Foreign Enterprises, originally issued in 1983. Although these measures have yet to be updated, the government sent out two important circulars earlier this year: the Notice on Further Reinforcement of the Registration of Representative Offices of Foreign Enterprises (Gongshangwaiqizi [2010] No. 4), or Circular 4 jointly issued by the State Administration for Industry and Commerce, and the Ministry of Public Security; and the Provisional Measures for Tax Collection and Administration of Representative Offices of Foreign Enterprises (Guoshuifa [2010] No. 18), or Circular 18 issued by the State Administration of Taxation.

**Tighter administrative requirements**

**Notarization and verification mechanism on registration**

Circular 4 reinforces the requirement for foreign official documents to be notarized...
Circular 4 specifies that if a representative office is found operating a fee-charging business, it should be penalized for operating without a business licence.

Validity and renewal of business registration certificates
To unify various practices in different locations, Circular 4 reaffirms the one-year validity of a business registration certificate of a representative office. For those issued certificates with more than one year’s validity, replacement is required upon change of registration or renewal. The one-year requirement is not new and was specified in the 1983 measures. However, in practice, different local authorities may have granted longer validity to some representative offices for easy administration. Its strict implementation would intensify governance over representative offices and increase compliance costs for foreign investors.

Limitation on headcount
Circular 4 limits the maximum number of employees of a representative office to four, including the chief representative. Any existing representative office with more than four staff would not be allowed to register a new representative. As such, the representative office may not be able to bring additional expatriates to work there and would be limited in expanding its operations.

Penalty on ultra vires business activities
Circular 4 specifies that if a representative office is found operating a fee-charging business, it should be penalized for operating without a business licence. Under the 1983 measures, if a representative office is found to be engaged in ultra vires activities, it will be ordered to terminate its operations and pay a maximum fine of 20,000 yuan. While the fine may be minimal, it is important to note that Circular 4 has required information exchange between the State Administration for Industry and Commerce and the Public Security Bureau on various non-compliance activities carried out by representative offices.

Closer inspection and supervision
Circular 4 requires local SAIC offices to inspect a representative office within three months upon issuance of a business registration certificate. A credibility system will be set up by the local offices to classify representative offices into different categories based on previous non-compliance records for ongoing supervision.

New tax regulations
In addition to tightening governance, representative offices face increasing taxes. Under Circular 18, representative offices are liable to corporate income tax at the statutory rate of 25 percent on its taxable profit, business tax and value-added tax.

Re-addressing the two tax assessment bases
Consistent with those stipulated in previous circulars Guoshuifa [1996] No.165 and Guoshuifa [2003] No.28, Circular 18 re-addresses the two tax assessment bases for representative offices, namely actual profit method and deemed profit method.

(i) Actual profit method
Under this method, a representative office’s taxes are assessed on an actual basis if it keeps proper books and records, and can accurately account for the taxable income commensurate with the functions it performs and the risks it assumes. Representative offices of foreign law firms and accounting firms adopt this method.

The transfer pricing principles have been extended to the taxation of representative offices, with PRC tax authorities requiring profits attributable to a permanent establishment (that is, a representative office) to comply with the arm’s length principle. Some local tax authorities have required representative offices adopting the actual profit method to submit the related party transaction forms in their 2009 annual corporate income tax filing. Disclosure of transactions with its overseas related parties and other relevant financial information may be required to substantiate intercompany pricing policies in case of a tax audit.

(ii) Deemed profit method
If a representative office does not have proper financial records, cannot come up with accurate amounts of revenue, costs or expenses, and is unable to report taxes based on the actual profit method, the tax
Because of this change, representative offices previously enjoying zero tax liability have started paying taxes from January 2010... Many local tax bureaus have requested representative offices to undergo a tax reassessment upon the issuance of Circular 18.

Table 1

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<tr>
<th>Cost-plus method</th>
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<tr>
<td>Gross income</td>
<td>Total expenditure for current period</td>
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<tr>
<td></td>
<td>1 - 15% (deemed profit rate) - 5% (BT rate)</td>
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<tr>
<td>CIT payable</td>
<td>Gross income x 15% (deemed profit rate) x 25% (CIT rate)</td>
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<tr>
<td>BT payable</td>
<td>Gross income x 5% (BT rate)</td>
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<th>Actual revenue method</th>
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<tr>
<td>Taxable income</td>
<td>Total revenue x 15% (deemed profit rate)</td>
</tr>
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BT: business tax
CIT: corporate income tax

Abolishment of tax exemptions

Guoshuifa [1996] No.165 granted tax exemptions to representative offices engaged in activities such as gathering of information about the China market, providing business information, liaison and other preparatory or auxiliary activities for the production or sale of products by their head offices. Exemptions were also given to representative offices set up by foreign governments, non-profit institutions and non-governmental organizations that are not engaged in taxable activities as stipulated in relevant rules. Circular 18 removed these exemptions. However, foreign investors from a jurisdiction with a double tax treaty with China can keep the treaty benefits.

Because of this change, representative offices previously enjoying zero tax liability have started paying taxes from January 2010. In fact, many local tax bureaus have requested representative offices to undergo a tax reassessment upon the issuance of Circular 18.

Time to rethink

The new administrative requirements and taxation rules will certainly affect the operation of representative offices, particularly for those foreign enterprises that are considering expanding operations in China through their existing representative offices. Foreign enterprises may need to consider appropriate actions to streamline their structures, headcount and operation arrangement to mitigate potential non-compliance risks.

They may also consider if a representative office is still the appropriate business vehicle. More and more foreign enterprises are thinking of converting their representative offices into wholly foreign-owned enterprises once their business operations in China are relatively mature.

Nevertheless, a representative office may still be a useful business vehicle when a company’s investment in China is limited, and it can serve as a good stepping stone to explore the China market at managed risk.

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