

China Tax & Investment News

China strengthens tax administration on non-resident companies

State Administration of Taxation releases new corporate income tax returns for non-resident companies

Executive summary

The taxation of non-resident companies is stipulated in Articles 2 and 3 of the Chinese Corporate Income Tax Law (CITL).

Article 2 defines a non-resident company to be a company established under foreign laws and effectively managed outside mainland China, but which has an establishment or place of business (hereinafter referred to as "PE") within the Mainland; or which does not have a PE within the Mainland, but derives China-sourced income.

Article 3 stipulates that a non-resident company with a PE within Mainland China should pay Corporate Income Tax (CIT) on China-sourced income derived therefrom and any foreign-sourced income effectively connected to the PE. For a non-resident company having no PE within Mainland China, or whose income is not effectively connected to its Chinese PE, the company should pay CIT on its China-sourced income only.

With regard to the tax administration of non-resident companies, the State Administration of Taxation (SAT) issued a circular, Guoshuihan [2008] No. 44 (Circular 44) in January 2008, containing four CIT return forms, two of which are applicable to non-resident companies, namely, the Monthly/Quarterly Provisional CIT Returns (Form B) and the Withholding Tax Return. Please refer to our China Tax and Investment News Issue No. 2008002 for a sample of these forms.

Despite the issuance of the abovementioned tax return forms, it remains not entirely clear how a non-resident company which has a PE within mainland China should file a CIT return. On 22 September 2008, the SAT issued a circular, Guoshuihan [2008] No. 801 (Circular 801), together with five new sets of CIT return forms to clarify this.

In what appears to be a concerted effort, tax authorities in certain provinces also issued Trial Tax Collection and Administrative Measures for Non-Resident Companies (hereinafter referred to as the "Trial Measures") to strengthen tax administration on non-resident companies.

This issue recaps the source concept of taxation associated with non-resident companies, introduces the five sets of new CIT return forms, and provides some insights for company executives' attention.

China source rules and PE

The Chinese CIT tax net covers both resident companies and non-resident companies. Resident companies are subject to CIT on a worldwide basis; whereas non-residents are subject to CIT in the following circumstances:

- (a) A non-resident company with a PE within mainland China should pay CIT on China-sourced income derived by such PE and any foreign-sourced income effectively connected thereto
- (b) A non-resident company having no PE in mainland China, or with a PE within mainland China but whose income is not effectively connected to such PE, should pay CIT on China-sourced income only

For CIT purposes, a non-resident company refers to a company established under foreign laws with its place of effective management maintained outside mainland China, but which has a PE within the Mainland, or which does not have a PE within the Mainland, but derives China-sourced income.

Five new CIT return forms

Circular 44, issued on 23 January 2008, contains four different CIT return forms, two of which, as listed below, are currently used for filing CIT for representative offices (ROs) and non-resident companies:

- ▶ The Monthly/Quarterly Provisional CIT Return (Form B) (Type B CIT Return)
- ▶ The Withholding Tax Return (WHT Return)

You can access Circular 44 and the current returns forms via our previous issue of the China Tax and Investment News (Issue No. 2008002) by clicking the following URL:

[http://www.ey.com/Global/assets.nsf/China_E/CTIN_0208/\\$file/CTIN2008002\(ENG\).pdf](http://www.ey.com/Global/assets.nsf/China_E/CTIN_0208/$file/CTIN2008002(ENG).pdf)

As indicated in the newly issued Circular 801, the two return forms listed above should continue to be used for the 2008 fourth quarter provisional CIT filing, and for withholding tax filing up to 31 December 2008.

The following five sets of new CIT return forms will be used effective from the period indicated below:

- ▶ Non-resident company annual CIT return form (actual basis): for the 2008 annual filing and thereafter
- ▶ Non-resident company quarterly CIT return form (actual basis): for the 2009 first quarter filing and thereafter
- ▶ Non-resident company annual CIT return form (deemed basis): for the 2008 annual filing and thereafter
- ▶ Non-resident company quarterly CIT return form (deemed basis): for the 2009 first quarter filing and thereafter
- ▶ Withholding company CIT reporting form: will supersede WHT Return effective from 1 January 2009

You can access Circular 801 as well as the relevant return forms by clicking the following URL:

http://www.hzguoshui.gov.cn/portal/tempp11/message_display.jsp?article_id=20081117000009

Insights from the explanatory notes accompanying the new tax returns

According to the explanatory notes to the actual and deemed basis returns, the quarterly and annual CIT return forms for non-resident companies can be used by ROs and foreign enterprises rendering services, engaging in contractor projects, and so on. Use of the form for actual basis or deemed basis depends on whether complete and accurate supporting documentation for costs and expenditure exist for the correct calculation of taxable income.

Although Circular 801 does not stipulate that the old Type B CIT Return, as per Circular 44, will be superseded by the actual basis form or the deemed basis form, a logical deduction from the explanatory notes, and further to our verbal inquiry with the SAT, confirms that companies should no longer use the Type B CIT Return for 2009 first quarter CIT filing.

The new deemed basis return forms (both annual and quarterly) and the Type B CIT Return differs in the formula for calculating income based on office expenses incurred. The formula stated in the explanatory note to the old Type B CIT Return is as follows:

$$\text{Income} = \frac{\text{Total Expenses}}{(1 - \text{Deemed profit rate})}$$

However, the formula has been revised to take into account the relevant Business Tax (BT) and the following formula is shown in the explanatory notes to the new annual and quarterly deemed basis return forms:

$$\text{Income} = \frac{\text{Total Expenses}}{(1 - \text{Deemed profit rate} - \text{BT rate})}$$

Assuming a deemed profit rate of 10% and total annual expenses of RMB 765,000, the additional annual CIT payable would be:

$$\begin{aligned} \text{Additional annual CIT payable} &= \left(\frac{765,000}{1-10\%-5\%} - \frac{765,000}{1-10\%} \right) \times 25\% \\ &= 12,500 \text{ (i.e., an increase of 5.88\%)} \end{aligned}$$

Company executives overseeing mainland China operations that are taxed based on the above method, for instance certain ROs, should keep a watch for the above increase in CIT payment and confirm with relevant tax authorities that this potential increase is actually applicable to your companies.

Trial tax administration measures for non-resident companies

Further to the latest changes associated with CIT return forms for non-resident companies at the central government level, the state tax bureaux of Hubei and Jiangxi provinces issued the Trial Administrative Measures for Non-Resident Companies. You can access the relevant Trial Measures via the following URLs:

Trial Measures of Hubei:
<http://219.140.162.54/taxnet/datx/hbgs/2008/egsf-2008-93-1.doc>

Trial Measures of Jiangxi:
<http://www.jx-n-tax.gov.cn/law/sj/200810/10817.html>

Company executives also need to stay tuned for any future Trial Measures that may be issued in the provinces where your companies have a presence.

Contact us

Beijing:

► Corporate tax partners

Alan Lan
Tel: +86 10 5815 3389
alan.lan@cn.ey.com

Andy Chen
Tel: +86 10 5815 3381
andy.chen@cn.ey.com

Gregory Buteyn (US Desk)
Tel: +86 10 5815 3394
gregory.buteyn@cn.ey.com

Henry Chan
Tel: +86 10 5815 3397
henry.chan@cn.ey.com

Joseph Lee
Tel: +86 10 5815 3383
joseph.lee@cn.ey.com

Lucy Wang
Tel: +86 10 5815 3809
lucy-c.wang@cn.ey.com

Martin Ngai
Tel: +86 10 5815 3231
martin.ngai@cn.ey.com

Si-Si Xiang
Tel: +86 10 5815 2822
si-si.xiang@cn.ey.com

Terry Wang
Tel: +86 10 5815 2855
terry.wang@cn.ey.com

Dalian:

► Corporate tax partners

Andy Chen
Tel: +86 411 8252 8883
andy.chen@cn.ey.com

Guangzhou:

► Corporate tax partners

Enoch Chan
Tel: +86 20 2881 2738
enoch-yt.chan@cn.ey.com

Rio Chan
Tel: +86 20 2881 2878
rio.chan@cn.ey.com

Hangzhou:

► Corporate tax partners

Patricia Xia
Tel: +86 571 8736 5058
patricia.xia@cn.ey.com

Hong Kong:

► China corporate tax partners

Becky Lai
Tel: +852 2629 3188
becky.lai@hk.ey.com

Clement Yuen
Tel: +852 2629 3355
clement.yuen@hk.ey.com

David Chan
Tel: +852 2629 3228
david.chan@hk.ey.com

Loretta Shuen
Tel: +852 2629 3778
loretta.shuen@hk.ey.com

Simon Wang
Tel: +852 2629 3233
simon-sm.wang@hk.ey.com

Shanghai:

► Corporate tax partners

Alfred Shum
Tel: +86 21 2228 2298
alfred.shum@cn.ey.com

Audrie Xia
Tel: +86 21 2228 2886
audrie.xia@cn.ey.com

Brian-Joseph Foley (TARAS)
Tel: +86 21 2228 2069
brian-joseph.foley@cn.ey.com

Carrie Tang
Tel: +86 21 2228 2116
carrie.tang@cn.ey.com

Chris Finnerty (US Desk)
Tel: +86 21 2228 3005
chris-j.finnerty@cn.ey.com

Derek Chow
Tel: +86 21 2228 3009
derek.chow@cn.ey.com

Genqiang Gao
Tel: + 86 21 2228 2105
genqiang.gao@cn.ey.com

Ivan Chan
Tel: +86 21 2228 2888
ivan.chan@cn.ey.com

Jean-Bernard Caumont
(Continental Western Europe Desk)
Tel: +86 21 2228 2669
jean-bernard.caumont@cn.ey.com

Michael Lin
Tel: +86 21 2228 3007
michael-cs.lin@cn.ey.com

Patricia Xia
Tel: +86 21 2228 2878
patricia.xia@cn.ey.com

Robert Smith
(Customs & International Trade)
Tel: +86 21 2228 2328
robert.smith@cn.ey.com

Sarah Chan
Tel: +86 21 2228 2327
sarah-kw.chan@cn.ey.com

Stephen Lee
Tel: +86 21 2228 2880
stephen.lee@cn.ey.com

Titus von dem Bongart (German Desk)
Tel: +86 21 2228 2884
titus.bongart@cn.ey.com

Vickie Tan
Tel: + 86 21 2228 2648
vickie.tan@cn.ey.com

Walter Tong
Tel: +86 21 2228 2186
walter.tong@cn.ey.com

Shenzhen:

► Corporate tax partners

David Chiu
Tel: +86 755 2502 8180
david.chiu@cn.ey.com

Mak Ho Sing
Tel: +86 755 2502 8289
ho-sing.mak@cn.ey.com

Suzhou:

► Corporate tax partners

Audrie Xia
Tel: +86 512 6763 3186
audrie.xia@cn.ey.com

Tianjin:

► Corporate tax partners

Alan Lan
Tel: +86 22 5819 3566
alan.lan@cn.ey.com

Xiamen:

► Corporate tax partners

Rio Chan
Tel: +86 592 329 3188
rio.chan@cn.ey.com

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