

update

CHINA LEGAL FOCUS

MARCH 2010



**New Circular Regarding
Income Tax for Non-Resident
Enterprises under the Deemed
Profit Method**

New Circular Regarding Income Tax for Non-Resident Enterprises under the Deemed Profit Method

Background

On 20 February 2010, the PRC State Administration of Taxation ("SAT") issued Tax Circular Guoshuifa [2010] No. 19 ("Circular No. 19"), i.e. the Notice Regarding the Issue of Administrative Measures on Taxation of Non-Tax-Resident Enterprises with a Deemed Profit Method. Non-Tax-Resident Enterprises ("non-TREs") are foreign enterprises whose effective management bodies are located outside China. Circular No. 19 was published on the SAT's website on 1 March 2010 and took effect from 20 February 2010. It has major implications for taxation of permanent establishments of foreign companies in the PRC.

Circular No. 19 clarifies the tax calculation methods for Corporate Income Tax ("CIT") payable by non-TREs on their operational profits in China and raises the deemed profit rates. It also covers the allocation between supply prices and service fees and between onshore and offshore services.

Main Content

The main content of the Circular can be summarised as follows:

— Taxation Methods

The Circular allows two methods for calculating CIT payable on operational profits of a non-TRE, i.e. the actual income method and the deemed profit method.

If a non-TRE can correctly record the revenue, costs and expenses for its operational activities in China, it can declare CIT based on the actual profits. Alternatively, the deemed profit method can be used. There are three different versions of the deemed profit method:

- (1) Deemed profit based on revenue, i.e. $\text{deemed profits} = \text{revenue} \times \text{deemed profit rate}$;
- (2) Deemed profit based on expenses and costs, i.e. $\text{deemed profits} = \text{expenses and costs} / (1 - \text{deemed profit rate})$; and

- (3) Deemed profit based on expenditure, i.e. $\text{deemed profits} = \text{expenditure} / (1 - \text{business tax rate} - \text{deemed profit rate}) \times \text{deemed profit rate}$.

— Increase of Deemed Profit Rates

The new Circular has increased deemed profit rates from 10%–40% to 15%–50%. The new deemed profit rates are as follows:

- (1) For construction and engineering projects, design and consulting: 15%–30%;
- (2) For management services: 30%–50%;
- (3) For other services: no less than 15%.

If the tax authority discovers that the actual profit rate is clearly higher than the above range, it is entitled to use a higher rate.

The applicable deemed profit rate for each project must be proposed by the non-TRE by submitting a standard form for verification by the tax authority.



— **Allocation of Prices for Goods/Equipment and Services**

If a non-TRE sells equipment or goods to a Chinese customer and provides services such as installation, supervision or technical training, the contract must specify the split between supply price and service fees. If no such allocation is included in the contract, or the service fees stipulated in the contract are unreasonably low, the tax authority is entitled to deem at least 10% of the contract value to be service fees and to levy taxes on the service fees accordingly. In the past, under the old Circular Guoshuifa [1995] No. 197, the minimum deemed service fees were 5% of the contract value.

— **Offshore and Onshore Services**

Offshore services are not subject to CIT in the PRC. According to Circular No. 19, non-TREs must ensure that the allocation between service fees for onshore and offshore services is reasonable. In case of doubt, the tax authority is entitled to ask for evidence such as travel schedules and working schedules to verify the

reasonableness of the allocation. If no evidence is provided, all the services will be regarded as onshore services.

- According to Circular No. 19, tax authorities at provincial level are entitled to work out further details to serve as a practical guide for the local tax authorities under their jurisdiction.

CMS Comments

- There is still some uncertainty surrounding interpretation and implementation of Circular No. 19. For example, where ongoing projects with contracts concluded before 10 February 2010 are concerned, the tax authority may have already fixed a deemed profit rate which may be lower than those provided by Circular No. 19. In such cases, it is not clear whether the tax authority must immediately adjust the deemed profit rate according to Circular No. 19. If such adjustments are made, foreign companies with existing PEs may have a higher tax burden, which would not have been taken into account when calculating the contract price.

- For new contracts, non-TREs must include the increase in the deemed profit rates in their business calculations.

- It will be important in future to make sure that the breakdown shown in contracts between supply prices and service fees and between onshore and offshore services can be successfully defended against any potential challenge by PRC tax authorities.

This information is provided for general information purposes only and does not constitute legal or professional advice. Copyright by CMS Hasche Sigle.

For further information, please contact **Dr Ulrike Glück** or **Charlie Sun** at

CMS Hasche Sigle Shanghai Office
 Room 2801-2812, Plaza 66 Tower 2
 1366 Nanjing Road West,
 Shanghai 200040, PRC
T +86 21 6289 6363
F +86 21 6289 0731
E shanghai@cms-hs.com

CMS Hasche Sigle is one of the leading commercial law firms. More than 600 lawyers serve their clients in nine major German commercial centres as well as in Belgrade, Brussels, Moscow and Shanghai. CMS Hasche Sigle is a member of CMS Legal Services EEIG, a European Economic Interest Grouping that coordinates an organisation of independent member firms. CMS Legal Services EEIG provides no client services. Such services are solely provided by the member firms in their respective jurisdictions. In certain circumstances, CMS is used as a brand or business name of some or all of the member firms. CMS Legal Services EEIG and its member firms are legally distinct and separate entities. They do not have, and nothing contained herein shall be construed to place these entities in, the relationship of parents, subsidiaries, agents, partners or joint ventures. No member firm has any authority (actual, apparent, implied or otherwise) to bind CMS Legal Services EEIG or any other member firm in any manner whatsoever.

CMS member firms are: CMS Adonnino Ascoli & Cavasola Scamoni (Italy); CMS Albiñana & Suárez de Lezo, S.L.P. (Spain); CMS Bureau Francis Lefebvre (France); CMS Cameron McKenna LLP (UK); CMS DeBacker (Belgium); CMS Derks Star Busmann (The Netherlands); CMS von Erlach Henrici Ltd. (Switzerland); CMS Hasche Sigle (Germany) and CMS Reich-Rohrwig Hainz Rechtsanwälte GmbH (Austria). www.cmslegal.com

CMS offices and associated offices: Amsterdam, Berlin, Brussels, London, Madrid, Paris, Rome, Vienna, Zurich, Aberdeen, Algiers, Antwerp, Arnhem, Beijing, Belgrade, Bratislava, Bristol, Bucharest, Budapest, Buenos Aires, Casablanca, Cologne, Dresden, Duesseldorf, Edinburgh, Frankfurt / Main, Hamburg, Kyiv, Leipzig, Ljubljana, Lyon, Marbella, Milan, Montevideo, Moscow, Munich, Prague, São Paulo, Sarajevo, Seville, Shanghai, Sofia, Strasbourg, Stuttgart, Utrecht, Warsaw and Zagreb. The members of CMS are in association with The Levant Lawyers (TLL) with offices in Abu Dhabi, Beirut, Dubai and Kuwait City.

The sole purpose of this publication is to provide information about specific topics. It makes no claims to completeness and does not constitute legal advice. The information it contains is no substitute for specific legal advice. If you have any queries regarding the issues raised or other legal topics, please get in touch with your usual contact at CMS Hasche Sigle or the publisher of this document. CMS Hasche Sigle 2009, Partnership of lawyers and tax consultants, registered office of the partnership: Berlin, court of registration: Charlottenburg, district court, PR 316 B, list of partners: s. website.

www.cms-hs.com