

Taxation of Foreign Enterprises in the People's Republic of China

Foreign enterprises with an establishment in the PRC and foreign enterprises without establishment in the PRC but which derive income from the PRC are subject to taxes in the PRC. However, foreign enterprises without establishments in the PRC are taxed on a withholding basis. The *PRC Interim Regulations for Business Tax* effective as of 1 January 1994 and the *Detailed Rules for Implementing the PRC Interim Regulations for Business Tax* effective as of the same date, the *PRC Corporate Income Tax Law* (“CIT Law”) and its *Implementing Rules* effective as of 1 January 2008 and other various notices and circulars concerning the taxation of foreign enterprises issued by the PRC State Administration of Taxation form the legal basis of taxes which are levied on foreign enterprises in the PRC. In addition, the relevant Double Taxation Treaties between the PRC and the country of incorporation of a foreign enterprise apply.

Background of the CIT Law

The *PRC CIT Law* was published on 16 March 2007 to unify the previous two income tax systems respectively for domestic enterprises and foreign invested enterprises as well as foreign enterprises. The *Implementing Rules of the CIT Law* was issued on December 6, 2007. Both the *CIT Law* and its *Implementing Rules* took effect on January 1, 2008.

Tax Resident Enterprise

The *CIT Law* has introduced the concept of a tax resident enterprise (“TRE”). TRE is defined as an enterprise which is established in the PRC under the PRC laws and regulations, or which has its place of effective management in the PRC. TREs will be subject to PRC CIT for their worldwide income. According to Article 4 of the *Implementing Rules*, “place of effective management” shall refer to the establishment that exercises essential management and control over the enterprise. Therefore, a foreign enterprise may also be regarded as a TRE and be subject to PRC CIT for its worldwide income if its place of effective management is located in the PRC.

Permanent Establishment

The concept of Permanent Establishment (“PE”) is used in Double Taxation Treaties (“DTT”) for the purpose of determining the right of a contracting state to tax the business remuneration and profits of an enterprise of the other contracting state. It refers to a fixed place of business through which the business of an enterprise is wholly or partly carried out. According to most Double Taxation Treaties signed by China, provision of onshore services, including consultancy services, by a foreign enterprise through employees or other personnel engaged by the enterprise for a project or connected projects that continues for a period or periods in aggregate of more than six months within any twelve-months period will constitute a permanent establishment in the PRC. According to the relevant DTT, the income attributable to the PE shall be subject to CIT in the PRC.

Taxation for Active Income - Foreign Enterprises as Service Providers

1. Off-shore Services

Off-shore services provided outside China to a Chinese entity or individual are subject to Business Tax since 2009.

2. On-shore Services

(1) Business Tax

According to the *PRC Interim Regulations for Business Tax*, services provided to or provided by a PRC entity or individual shall be subject to business tax in China. For most categories of services, the applicable tax rate is 5%. However, education, transportation and construction services are eligible to a tax rate of 3%. Please note that for technology development services, business tax exemption is available if the contract has been registered with the competent technology authority as a technology development contract.

In addition, starting from December 2010, foreign enterprises shall also pay certain Surcharges calculated at certain percentages of the Business Tax / VAT. The so-called City Maintenance and Construction Tax ("CMCT") is calculated at 7%, 5% or 1% of the Business Tax / VAT payment depending on the location of the tax authority (downtown, township areas or other areas). The Education Surcharge is calculated at 3% of Business Tax / VAT payment. There might be other local Surcharges in some cities/provinces. E.g. in Shanghai, there is a so-called River-Management-Fee calculated at 1% of Business Tax / VAT payment.

(2) Corporate Income Tax

In case the on-shore services constitute a PE in China according to the relevant Double Taxation Treaty, the on-shore service fees shall also be subject to CIT in China. The current standard CIT rate is 25%. Normally, CIT payable for on-shore service fees derived by a foreign enterprise is calculated based on a deemed-profit rate method. According to the Tax Circular *Guoshuifa [2009] No. 19*, starting from February 20, 2010, the deemed profit rate ranges from 15% to 50% according to the types of activities of the PE. Under the above Circular, the deemed profit rate for technical services shall be no less than 15%.

(3) Individual Income Tax

In case of a PE, the expatriates who work under the PE are subject to Individual Income Tax in China regardless of how long they have stayed in the PRC. Such expatriates are not entitled to the temporary visitor's tax relief provided by the relevant Double Taxation Treaty because their employment costs are deemed to be borne by the PE of the foreign employer in the PRC.

(4) Stamp Duty

According to the *PRC Interim Regulations for Stamp Duty* and the *Detailed Rules for Implementing the PRC Interim Regulations for Stamp Duty*, technical service contracts are subject to stamp duty at the rate of 0.03% of the contract price. However, normal consulting services are not subject to stamp duty in China.

Taxation for Passive Income - Profits, Dividends, Interests, Rentals, Royalties

1. Withholding Tax ("WHT")

Profits, dividends, interest, rental, royalty and other passive income derived from sources in the PRC by a foreign enterprise without an establishment in the PRC or the incomes of a foreign enterprise derived in the PRC which are not related to an establishment of the foreign enterprise in the PRC are subject to CIT on a withholding basis, as so called "Withholding Tax".

Withholding income tax is imposed on the gross amount of each item of income received and generally no deduction is permitted.

According to the *CIT Law*, the statutory WHT rate is 20% which is reduced to 10% by the *Implementing Rules of the CIT Law* as a tax preferential treatment. The withholding tax rate specified in the PRC tax law and regulations may be further reduced if a lower rate is applicable according to the relevant double taxation treaties.

WHT for dividends distributed by foreign investment enterprises to its foreign shareholders in the past were exempted from WHT. However, such exemption has been abolished by the *CIT Law*. Despite that, WHT exemption still applies for distribution of dividends of FIEs out of their profits generated before 1 January 2008.

2. Business Tax

In addition to WHT, certain items of income, e.g. royalties and rentals from immovable properties in the PRC, are subject to Business Tax in the PRC at an applicable rate of 5% on a withholding basis. Whenever Business Tax is payable, Surcharges linked to Business Tax shall also be calculated and paid.

Withholding Agents

In most cases, a Chinese company which pays taxable income to a foreign enterprise is obliged to act as withholding agent and is responsible for filing tax returns and remitting tax payments to the tax authorities on behalf of the foreign enterprise. However, in case of CIT payable by a PE, in principle, the non-TRE shall be responsible for the CIT declaration.

Due to foreign exchange control in China, the relevant tax payment confirmation letter issued by the competent tax authorities shall be submitted to the handling bank when the PRC company pays service fees, dividends, interests, royalties, rentals and etc. to the foreign enterprise abroad.

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