TAX BRIEF

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CHANGES TO REPRESENTATIVE OFFICE REGULATIONS

Is an RO the right way to go?

In 2010, the PRC government issued multiple reforms on the representative office (RO) structure, with the most recent set of regulations coming into force from March 1st 2011. The changes will have a profound impact on existing ROs and for foreign businesses looking for the right investment structure to enter the Chinese market.

S.J. Grand has analyzed the changes to help your business decide how best to adapt to the new regulatory regime.

KEY POINTS:

- Modified tax structure for ROs will force companies to reevaluate their tax rates.
- New penalties for violations of profit-making prohibition carry higher fines and heavier repercussions.
- Timeframe for registration of Representative Offices has increased, along with need to prove an established company track record.
- New annual reporting obligations added and requirement for submissions of official audits

OVERVIEW

Traditionally, the RO structure has been used by companies as an initial entry into the Chinese market to test the waters, and is prohibited from engaging in profit-making activities. It has been particularly popular because there is no registered capital required to set up an RO, and excluding a few select industries, there is no approval required for RO establishment. However, in recent years the number of businesses abusing the RO structure has increased, and the government is now seeking to crack down on illegal profit-making activities. The new regulations, issued in three parts, seek to raise requirements for establishing ROs and increase penalties for those in violation of PRC law.

INCREASING RESTRICTIONS

The first set of new regulations, titled "Registration Administration Measures on Residential Representative Offices of Foreign enterprises" released on January 4th, 2010, introduced two main changes tightening restrictions for RO operation:

1. Each RO can have a maximum of four representatives, including the chief representative of the Rep office;

2. A two year operating history is now required for a company to establish an RO

By raising the operating history requirement companies now cannot simply incorporate in Hong Kong and quickly launch a RO in China. Instead, they must have a proven track record before establishing an RO in Mainland China. This new rule, along with the restrictive rules on the number of foreign reps in RO offices decreases the attractiveness of choosing the RO structure.

CHANGES IN TAX STRUCTURE

The second set of new regulations, "Provisional Measures on Tax Administration of Representative Offices of Foreign Enterprises" (Circular 18), were issued February 20th, 2010, and cover new tax regulations regarding ROs. The first significant part of this set of regulations is that Circular 18 overrules previous tax circulars and *revokes RO exemption from foreign enterprise income tax*. Despite the prohibition of ROs conducting profit-making activities, the continuing phenomenon of certain ROs circumventing established regulations has led the Chinese government to presume ROs are participating in such activities and have created a new tax metric to calculate how much tax each RO will pay. The new regulations in Circular 18 lay our three separate methods for how to calculate income tax from Rep Offices.

The first method is based on a Rep Office's financial records and statements. If an RO has the means to accurately calculate its revenues and expenses, then it is required to prepare accounting books in order to determine its taxable income. However, there is still some ambiguity as to how taxable income should be accurately determined, since the law states taxable income should be calculated "in accordance to actual performance function and business risk." Companies will have to wait and monitor how tax bureaus will apply this statute to see how it will affect the final definition of "taxable income."

The other two methods for calculating the amount of payable taxes use a "deemed profit rate," and are assessed either by using an RO's total income or total expenditure as a basis. The new tax law raises the *minimum* deemed profit rate from 10% to 15% no matter which method is used.

The first formula is for an RO that can accurately determine its expenditures:

Income = Expenditures / (1 – deemed profit rate – business tax rate)

Amount of payable taxes = Income x deemed profit rate x enterprise income tax rate

The second method is for an RO that can accurately determine its income:

Amount of payable taxes = Income x deemed profit rate x enterprise income tax rate

Regardless of the method used, it should be noted that the deemed profit rate has been raised 5% (which represents a 24% tax increase), and this just establishes a minimum rate, subject to be raised by local tax bureaus if they believe it appropriate. This may cause a drastic shift in the tax burdens for your Rep Office, and could mean the RO structure is no longer the most efficient for your business.

INCREASING ACCOUNTABILITY

The third new set of regulations, "Registration Administration Measures on Residential Representative Offices of Foreign Enterprises" was published on November 19th, 2010, reiterates the rules issued in February along with introducing some substantial changes. The first is that ROs are restricted to only engaging in the following activities:

- Market research, exhibition and promotional activities connected to products and services of its Head Office

- Liaison activities in connection with sales of products, provision of services, domestic procurements and onshore investment of its foreign parent companies

In addition, ROs now must set up accounting books conforming to PRC standards. ROs are still required to submit an audit each year done by a third party accounting agency. However, new rules require Rep Offices to report to the AIC annually concerning its operating status, audited revenues, costs, and expenses, and the legal existence of its Head Office between March 1st and June 30th. It is currently unclear if this will replace the previous registration certificate renewal procedure.

These audits must be submitted within a four month window for inspection, meaning ROs must begin compiling information from 2010 and by the end of April 2011 have their accounts audited by a CPA firm and prepared for examination.

PUNITIVE MEASURES

Perhaps most significantly, the fines for engaging in profit-making activities have changed and become more severe. Whereas in the past the maximum fine for such violations was capped at RMB 20,000, the new cap has been raised to RMB 500,000, showing an increased emphasis on penalizing violators and encouraging those businesses making profits to incorporate in China as a wholly owned foreign enterprise (WOFE) or other similar structure.

The new regulations also allow authorities to confiscate any income and property (including raw materials and equipment) that was used in profit-making activities, and even revoke the ROs registration certificate if the situation is deemed serious enough. Accountability has been emphasized as chief representatives of ROs now face personal liabilities for violations by a Rep Office. Public announcements of changes to ROs or new RO establishment are also required, and neglecting to do so could result in penalties of up to RMB 30,000.

IMPLICATIONS: PREPARING FOR CHANGE

The main goals of the new regulations are to tighten registration restrictions and impose more severe penalties on violators to decrease the amount of ROs participating in profit-making activities. For businesses currently operating ROs in China, it is tempting to operate on the assumption that if authorities have overlooked violations by an organization in the past, they will continue to do so. This is a dangerous assumption that could prove incredibly costly in the new regulatory environment.

The changes in law reflect a conscious effort by the government to penalize those attempting to evade taxes and push businesses to move toward incorporated structures like WOFEs, since the deemed-profit basis for assessing taxable income creates vagaries and inequities in the system. Below is a brief checklist for ROs to consider before the new regulations come into effect on March 1st, 2011:

- Am I prepared to keep accounting books and records under PRC standards?

- Have I communicated with my local tax authorities to clarify any differences with the stated national changes?
- Have I evaluated the benefits/costs of transferring my RO's assets and switching to a WOFE or other structure?
- What amount of taxation would make it prohibitively expensive to maintain my RO?
- If I switch to a WOFE, will I have sufficient access to capital for my business?
- Do my local clients require invoices and want to be paid in RMB? (ROs cannot invoice a company)

For businesses currently looking to enter the Chinese market, the legal changes make the representative office a much less attractive option. Not only is it more difficult and time consuming to set up a Rep Office, tax exemption is now practically impossible to obtain unless provided by a double-tax agreement, and the taxation rate for a new RO could be prohibitively high. It is important to be sure your Rep Office's activities all fall under the exclusive list of activities permitted in the new regulations.

Every business is unique. The China tax and legal professionals at S.J. Grand are here to answer any questions that you have stemming from the new regulations. We can help you analyze your situation to determine what vehicle of investment to use, the benefits of moving from Rep Office to another vehicle, as well as how to efficiently come into compliance with all new regulations.

For more details contact an S.J. Grand office.

S.J. GRAND
Financial and Tax Advisory

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