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CHINA UPDATE

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Inside

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Recent Developments of PRC Tax Rules for Nonresident Enterprises

Key Points:

- ***New rules bring significant changes to the corporate income tax regime of nonresident enterprises with operations in China***
- ***The tax authority is now taxing the indirect transfer by a nonresident enterprise of its offshore intermediate company's holding interest in a China-based company under certain circumstances***

The Administrative Measures for the Collection of Corporate Income Tax on Non-tax Resident Enterprises on a Deemed Basis

On February 20, 2010 the State Administration of Taxation (SAT) promulgated the Administrative Measures for the Collection of Corporate Income Tax on Non-tax Resident Enterprises on a Deemed Basis, GuoShuiFa [2010] No. 19 (Circular 19). Circular 19 concerns the nonresident enterprise (NRE) that has a place of business (establishment) or a permanent establishment (PE)[1] in China. Under PRC corporate income tax law, if such NRE earns income in China attributable to the establishment/PE, the NRE is liable for 25-percent PRC corporate income tax. Circular 19 brings about significant changes to the corporate income tax regime of nonresident enterprises with establishments/PEs in China. The major changes are summarized as follows:

1. New Income Tax Calculation Method

Under the old rule, if the NRE cannot maintain complete and accurate accounting books, it will be taxed on a deemed profit basis – i.e., the NRE applies a deemed profit rate of 10 to 40 percent of its gross revenue to arrive at the taxable income.

Circular 19 provides the following calculation methods in the event that the NRE does not have complete and accurate records of its activities in China.

Deemed Profit Method

This method should be used when the NRE can accurately determine its gross revenue but cannot ascertain its costs and expenditures. The calculation formula is:

Taxable Income = Gross Revenue x Deemed Profit Rate

Cost Plus Method

This method should be used when the NRE can accurately determine its cost but cannot ascertain its gross revenue. The calculation formula is:

Taxable Income = Cost/(1 - Deemed Profit Rate) x Deemed Profit Rate

Expenditure Method

This method should be used when the NRE can accurately determine its expenditures but cannot ascertain its gross revenue and costs. The calculation formula is:

Taxable Income = Expenditures/(1 - Deemed Profit Rate - Business Tax Rate of 5 Percent) x Deemed Profit Rate

2. New Deemed Profit Rate

Circular 19 for the first time clarifies the deemed profit rates for various types of businesses, which used to be based on the practice of local tax authorities and vary significantly across the country. The deemed profit rates are defined as follows:

- Project construction, design and consulting: 15 - 30 percent
- Management services: 30 - 50 percent

[1] The NRE is a tax resident of a jurisdiction that has concluded a tax arrangement/treaty with China.

- Other services or activities: No less than 15 percent

Circular 19 also gives the tax bureau the authority to apply a higher rate if there is evidence that the actual profit rate of the NRE is noticeably higher than the prescribed rate.

It is also important to note that if the NRE conducts various types of businesses in China that are subject to different deemed profit rates, it should calculate the relevant tax liabilities separately.

3. After-Sales Services

Another important development under Circular 19 concerns the provision of after-sales services – e.g., installation, assembly, technical training, guidance and supervision in China provided by the NRE in connection with the sale of goods/equipment in China. If the sales contract fails to provide any fee for such after-sales service, or the service fee is not reasonable, the tax bureau is authorized to deem a service fee at a rate comparable to the same or similar services, or at no less than 10 percent of the total sales price if no such comparison exists.

4. Onshore and Offshore Services

Circular 19 seems to have abandoned the compulsory 60/40 allocation rule, which has been criticized by some commentators as arbitrary and inaccurate. According to this 60/40 allocation rule, if the NRE renders consulting services both in and outside China, the tax bureau requires at least 60 percent of the service revenue to be allocated as China-source income, regardless of what portion of the revenue was actually earned in China. Circular 19 appears to adopt a more reasonable approach towards services provided onshore and offshore: the NRE should allocate service income based on where the services are actually rendered and report only income derived from services rendered in China. However, if the tax authority has questions regarding the reasonableness and legitimacy of the allocation, it can require the NRE to produce supporting evidence and make its own allocation according to the work load, work schedule, cost and expenditures. If the NRE cannot provide the requested evidence, the tax authority may deem that all services were performed onshore and subject all revenue to PRC tax.

Notice on Strengthening the Administration of Corporate Income Tax Liability of Equity Transfer of Nonresident Enterprises

On December 10, 2009 the SAT issued the Notice on Strengthening the Administration of Corporate Income Tax Liability of Equity Transfer of Nonresident Enterprises GuoShuiHan [2009] No. 698 (Circular 698).

Circular 698 is significant as it marks the first time that the tax authority officially adopts the position of taxing the indirect transfer by a nonresident enterprise of its offshore intermediate company's holding interest in a China-based company under certain circumstances. Circular 698 provides that if a foreign investor or an effective controlling party, through abusive arrangements, disposes of its equity interest in an offshore intermediate company holding an interest in a China-based company, and such holding company does not have a reasonable commercial purpose and is established with the intent of avoiding PRC corporate income tax liabilities, the tax authority has the right to invoke the principle of "substance over form," disregard the existence of the holding company being used as a tax-avoidance vehicle, recharacterize the transaction as a transfer of the China-based company itself and impose PRC tax on the capital gains of the transfer. However, such recharacterization by the local tax bureau is subject to the review and approval of the SAT.

As part of its effort to strengthen the administration of equity transfers of nonresident enterprises, Circular 698 requires the nonresident enterprise disposing of its interest in a China-based company to file a corporate income tax return with the tax authority in charge of the transferee

China-based company if the withholding agent is unable to or fails to withhold corporate income tax within seven days after the execution of the equity transfer agreement or seven days after obtaining the equity transfer price if the nonresident is prepaid the equity transfer price.

Another important obligation imposed on nonresident enterprises with respect to the indirect transfer of a China-based company applies when the intermediate holding company is located in a jurisdiction where the effective tax rate is lower than 12.5 percent or its foreign-source income is exempted from income tax in that jurisdiction. In this scenario the nonresident enterprise is required to file the following with the tax authority in charge of the China-based company within 30 days of the execution of the equity transfer agreement:

- The equity transfer agreement;
- Information about the relationship between the nonresident transferor and its holding company transferee in terms of capital, business operation, purchases and sales;
- Information about the manufacturing activity, business operation, personnel, financials and properties of the holding company transferee;
- Information about the relationship between the holding company transferee and the China-based resident company in terms of capital, business operation, purchases and sales;
- An explanation of the reasonable commercial purpose of the holding company; and
- Other materials as required by the tax bureau.

Circular 698 not only increases the compliance burden for the nonresident enterprise but also creates great uncertainties for the nonresident enterprise with respect to the transfer of its offshore company's holding interest in a China-based company. The tax authority has not given any guidance on what constitutes "reasonable commercial purpose" and when it will invoke the "substance over form" principle. It is expected that detailed rules will be issued to address these issues.

– Sharon Xu

China Continues to Encourage Foreign Investment

Key Points:

- ***The Catalogue for the Guidance of Foreign Investment Industries will be amended to support specified industries***
- ***Various incentives in terms of tax exemptions, land use rights and preferential tax rate are available for eligible foreign-invested enterprises***
- ***Local government authorities are granted more powers to verify or approve foreign-invested projects***
- ***Antimonopoly review and national security review related to acquisitions will be strengthened***

In recognition of the concern among non-China-based companies that it has become increasingly difficult to conduct business in China, the State Council of the People's Republic of China issued the Opinions on Further Improving the Utilization of Foreign Investment (the Opinions) on April 13, 2010. The Opinions reflect the government's determination to continue to create a favorable environment for foreign investment.

According to the Opinions, China will amend the Catalogue for the Guidance of Foreign Investment Industries (the Catalogue) with the aim of encouraging foreign investment

in the advanced manufacturing, high- and new-technology, tertiary, new-energy and environmentally friendly industries, and to curb investment in sectors suffering overcapacity or causing pollution. In particular, the Opinions specify that policies will be developed to encourage foreign investment in the service outsourcing industry. In addition, as a part of China's development campaign for the middle and western regions of the country, foreign investment in certain labor-intensive industries in those areas will be encouraged provided that the investment complies with environmental protection requirements.

Qualified foreign-invested research and development centers in China will enjoy tax exemption – including import duty, import value-added tax and consumption tax – for commodities imported for research and development until December 31, 2010. The Opinions also offer land use incentives to foreign-invested projects with intensive land use in the encouraged categories of the Catalogue. Specifically, a qualified foreign-invested project may obtain the usage rights to a piece of land at a price of 30 percent less than the applicable statutory bottom price. The Opinions also provide that preferential corporate income tax policies shall be continuously applicable to eligible domestic and foreign-invested enterprises in the western region of China.

The encouragement of foreign investment is also reflected in the State Council's decision to authorize government authorities at the local level to approve or verify a foreign-invested project in the Catalogue's encouraged or permitted categories with a total investment amount of less than US$300 million, except for those projects that must be verified by the State Council according to the "list of investment projects with government approval." Prior to the issuance of the Opinions, local government authorities were allowed to approve a foreign-invested project with a total investment amount of less than US$100 million. In addition, the Opinions require government authorities to simplify the examination procedures and shorten the timeline for project review and approval.

The Opinions provide that China's government will encourage foreign investors to recapitalize domestic enterprises, support qualified foreign-invested enterprises (FIEs) in issuing securities in China's capital market and guide financial institutions in providing credit support to FIEs. The Opinions also encourage foreign investors to establish venture capital companies in China, which reflects a favorable attitude towards private equity funds. Moreover, the number of qualified overseas institutions authorized to issue RMB bonds will be steadily increased, according to the Opinions.

On the other hand, along with efforts to encourage foreign companies' acquisition of China-based companies, China will continue to conduct antimonopoly reviews and develop the legal system for national security review related to acquisitions, which may signal strengthened supervision of acquisitions and, consequently, increase the risks faced by foreign investors.

– Ryan Chen/Vincent Liu

China Practice Focus: Important Changes to PRC Labor Rules

Key Points:

- ***Businesses still have questions regarding compensation guidelines that went into effect with the January 1, 2008 adoption of the PRC Labor Contract Law***
- ***Local bureaus' interpretation of the Labor Contract Law's clause on open-ended contracts has raised concerns***

- ***Employers must take care not to expose themselves to liability under China's regulations on statutory vacations with pay***

Since the adoption of the PRC Labor Contract Law on January 1, 2008, there have been questions regarding how the law is applied, particularly to employment contracts that remained valid on and after January 1, 2008. *China Update* spoke with Laura Wang, a lawyer in the Squire Sanders Beijing office, about the law and how it has affected labor practices in China.

What are the most common questions about the Labor Contract Law with respect to the employment contracts in question?

Wang: The most common question our clients have asked with respect to employment contracts with commencing dates before January 1, 2008 but to be terminated after January 1, 2008 is how to calculate the economic compensation upon termination. The general concept is different rules apply to the service period before and after January 1, 2008. The PRC Labor Contract Law follows the principle of "one month's salary for one year" as provided by the PRC Labor Law, but the Labor Contract Law provides changes to the details. The follow chart shows the changes:

	Period Less Than Six Months	Cap on Monthly Salary	Termination Upon Expiration
Before Jan. 1, 2008	One month salary	One month salary for one year, no cap on monthly salary	Employer is not required to pay any economic compensation
After Jan. 1, 2008	Half month salary	Monthly salary is capped for no more than three times the average salary of the municipality where employer is located	Employer is required to pay economic compensation unless any exemption is applied

When terminating an employee, the employer must calculate the economic compensation for the period before January 1, 2008 by applying the then-effective rules and calculate the economic compensation for the period after that date by applying the Labor Contract Law. The sum of these two will be the total economic compensation payable to the employee.

The changes have a great impact on employees with high salary. We often see cases where a manager is terminated and the economic compensation he or she is entitled to for the period after January 1, 2008 is significantly less than the economic compensation he or she is entitled to for the service period before January 1, 2008. Because of the cap on monthly salary, the cost of terminating a senior manager is much less than it was before January 1, 2008. More and more companies prefer to terminate their managers through mutual consent by offering a termination package higher than the legally required minimum economic compensation under current rules but much lower than what they would have received under the old law before January 1, 2008.

When the Labor Contract Law was published, there were a lot of concerns about the employer's obligation to sign an open-ended contract. What is the practice today, and are there any particular areas where employers should be particularly careful?

Wang: This remains a concern. In fact, some local bureaus' interpretation of the clause on open-ended contracts makes this an even bigger concern. Article 14 of the Labor Contract Law provides that, "If any of the followings exists when the employee asks or agrees to renew or sign an employment contract, an open-ended contract shall be entered into unless the employee requests a fixed-term contract: … two consecutive fixed-term contracts have been signed and none of the situations listed in Section 39 or Section 40 Subparagraphs (1) and (20) exist" (Section 39 and Section 40 Subparagraphs (1) and (2) are statutory grounds entitling the employer to terminate the employee unilaterally with or without prior notice).

Many companies believe Article 14 (3) means that if both the employer and employee agree to renew the contract for the second time, the employee is entitled to an open-ended contract but the employer does not have to agree to renew for the second time. However, some local labor bureaus, such as the Beijing Labor Bureau, interpret Article 14 differently. They believe that after the employer renews the employment contract for the first time it has to renew the employment contract for the second time – unless the employee refuses to renew or there is a situation entitling the employer to terminate the employee – and the second renewal contract must be an open-ended contract unless the employee requests otherwise. This interpretation means that after a company renews the employment contract, the employee will become a permanent employee unless the company can terminate him or her on legal grounds.

What other issues should employers in China watch out for under the current PRC labor laws and regulations?

Wang: One thing many employers may overlook is vacation days. On January 1, 2008 a regulation on statutory vacations with pay took effect. That regulation provides the minimum number of vacation days to which employees are entitled. Such statutory vacation days can be carried over for one year with the employee's consent. Also if there are any unused statutory vacation days due to the employer's business demand, the employer is required to pay three times the daily salary in lieu of vacation for each unused vacation day. If the employer makes the vacation days available to the employee and the employee requests in writing to cash out, the employer is required to pay only the regular daily salary for each vacation day.

The common practice among employers is to ask employees to submit applications for vacation, which the employers may approve or deny. If at the end of a year an employee has unused vacation days and he or she did not apply for vacation days, the employer must allow them to be carried over to the next year. Over time, an employee could accumulate a large number of unused vacation days. This is not a good practice, as being passive and waiting for the employee to apply for vacation could expose the employer to the liability of paying three times daily salary in lieu of vacation.

The regulation on vacation days with pay requires the employer to be much more proactive in order to fulfill its obligation. The employer must make arrangements for the employee to take vacation time. The employer must remind the employee about the unused vacation days and even request that the employee take vacations. If the employee gives written notice that he or she will not take the vacation although the employer has made the necessary arrangements, the employer could be exempt

from the three times daily salary payment in lieu of vacation.

The statutory vacation days can be carried over, with the employee's consent, for one year. The employer must make the effort to arrange for the employees to take those carried-over vacation days in the next year. Otherwise, at the end of the next year, it will be obligated to pay those unused vacation days at the rate of three times daily salary.

Articles, Publications and Other Media

Daniel F. Roules was quoted by the *21st Century Business Herald* March 5 regarding the risk of class action litigation brought in the United States against China-based companies.

David M. Spooner was quoted March 23 by the *Financial Times* regarding punitive tariffs against China proposed by the US government in response to currency undervaluation. Mr. Spooner was also quoted March 23 on WWD.com about the anticipated move of apparel production from China to neighboring countries to avoid rising labor and production costs.

Daniel F. Roules and **Doris Chen** published an article in *China Law & Practice* magazine regarding renewed interest in Sino-foreign joint ventures.

Rainer Burkardt was interviewed recently by ARD, the German-language radio station in Shanghai, regarding corruption in China. Mr. Burkardt also published an article in *Chinamanager* magazine about China's updated regulations governing the registration of representative offices of foreign enterprises in China.

DefenseTech.org quoted **James M. Zimmerman** May 3 on the status of China's demand that security product vendors provide detailed descriptions of how computer products such as firewalls, secure network routers and antispam products function.

Past Events

On April 10-11 Squire Sanders lawyer **Brad Y. Chin** attended the China Low Carbon Economy Forum 2010, "Low Carbon City, Low Carbon Industry and Low Carbon Finance," which focused on research and forecasts for the development of China-based and global low carbon cities and low carbon economies, establishing a platform for low carbon businesses to be more effectively connected with financial capital, information sharing among low carbon pioneers, and seizing investment opportunities in the emerging low carbon industry.

On April 12 Squire Sanders national partner **Amy L. Sommers** joined Rocco deGrasse of KPMG LLP's Forensics Group at the KPMG offices in Chicago for a complimentary roundtable discussion of anticorruption enforcement issues in China – "China Enforcement Risks – They're Real and They're Out There."

Squire Sanders presented a complimentary webinar on April 19 titled "Intellectual Property Protection in China." **Song Zhu**, a partner in the firm's Beijing, San Francisco and Palo Alto offices, and **Amy L. Sommers** addressed the following questions:

- Is it worthwhile for US companies to register their IP in China?
- If US companies do register their IP in China, will China protect their rights?
- How effective is IP protection in China?
- What should US companies do if their IP is stolen or infringed?
- What are the forums for IP enforcement in China?

- Do China's courts favor companies based in China?
- Is IP litigation slow and expensive in China?
- If US companies prevail in court, will judgments be enforced?
- What steps can US companies take to prevent theft of their IP by their competitors in China, business partners and employees?

On May 7 Squire Sanders hosted a breakfast in its San Francisco office and lunch in its Palo Alto office to explore the wave of China-based business flooding into California and identify ways to capitalize on the changing environment. The presentation, "The How, When and Why of Doing Business with China," focused on market intelligence and how to identify potential partners, investors and/or customers in the China market.

Upcoming Events

On May 20 an authoritative panel of FCPA lawyers, including **Amy L. Sommers**, will examine the risks of FCPA violations when doing business in China, the interplay between the FCPA and local Chinese antibribery laws, and best practices for preventing FCPA violations. "Foreign Corrupt Practices Act in China for 2010 – Compliance Strategies Given China's Unique Cultural and Governmental Intricacies" will address the following questions:

- What risk factors increase the exposure of companies conducting business in China to possible FCPA violations?
- How are the US and Chinese governments acting to enforce their respective antibribery laws against US-based companies?
- What are the best practices for companies to utilize in developing anticorruption compliance programs and due diligence efforts for their China operations?

The panel will be followed by an interactive question and answer session.

Lawyers from Squire Sanders' Shanghai office will host a May 28 discussion on some of the key elements of international contracts that airline in-house lawyers must consider. See The Basics of International Contracts for the Aviation Industry for more details.

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