China Law Update

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China Issues New Rules For Non-Resident Enterprise Income Tax

On February 20, 2010, the State Administration of Tax (the "SAT") issued *"Measures on the Administration of Approval and Collection of Non-resident Enterprise Income Tax"* (the "Measures"). Non-resident corporations, defined in Article 3, Paragraph 2 of the Enterprise Income Tax Law of China, are governed by the Measures regarding enterprise income tax (EIT) issues. The EIT of representative offices of foreign enterprises is covered by Circular 18 [2010] issued by SAT on the same day. The Measures went into effect of the date of issuance.

Under the Measures, non-resident enterprises shall: set up their account books in accordance with the Law on the Administration of Tax Collection and relevant laws and regulations; record and settle their accounts in accordance with legal and valid invoices; and, in accordance with the principle of correspondence of actual functions to assumed risks, accurately calculate their taxable income, and report and pay the EIT for their actual situation.

If a non-resident corporation has not properly kept account books and cannot calculate the amount of its taxable income, the tax authority will use one of the following methods to decide the amount of payable EIT.

> (1) *Gross Income-Based Method* -- This method should be applied when a non-resident corporation calculates its gross income correctly but cannot accurately compute its costs and expenses. The formula is as follows:
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> Deemed taxable income = Gross income * Deemed profit rate
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> (2) *Cost-Based Method* – This method applies when a non-resident corporation calculates its costs and expenses accurately but cannot correctly compute its gross income. The formula is as follows:
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> Deemed taxable income = The total of costs and expenses / (1 – Deemed profit rate) * Deemed profit rate
>
> (3) *Expenditures-Based Method* – This method applies when a non-resident corporation accurately calculates its expenditure for operations but cannot correctly compute its gross income or its costs and expenses. The formula is as follows:

Deemed taxable income = Total of expenditure for operations / (1 – Deemed profit rate – EIT rate) * Deemed profit rate

The tax authority should use the deemed profits rate below when calculating the deemed taxable incomes:

(i) The deemed profit rate for income from project construction, design and consulting is 15% to 30%;
(ii) The deemed profit rate for income from management service is 30% to 50%;
(iii) The deemed profit rate for income from other business activities should be no less than 15%.

The tax authority may raise the profit rate if it reasonably holds, with good grounds, that the actual profit rate of a non-resident corporation is higher than the corresponding deemed profit rate. Where a non-resident corporation generates income from more than one type of the activities listed above, the tax authority shall divide the income from the different types of activities and apply appropriate deemed profit rate to the different elements of the income. If the income cannot be divided accurately, the higher deemed profit rate will be applied.

When a non-resident corporation provides equipment installment, training, management and other services to a Chinese resident buyer of its equipment or other goods, the sales contract of such equipment or goods may not stipulate the price of such related services, or the price of service may be unreasonable. In those cases, the tax authority can refer to the general price in the same or similar industry and decide the deemed income from the services provided. In case where there is no general price to refer to, the tax authority may decide the deemed income from the service, which should be no less than 10% of the total price of the sales contract.

With regard to non-resident enterprises providing labor services for customers located in China, if the entire service is provided within China, the revenue in full shall be subject to EIT in China. If the service is provided both inside and outside of China, then the revenue shall be divided by services provided within China and outside of China, and the revenue derived inside China shall be subject to EIT.

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