More Hardships for Representative Offices in China!

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At the start of a business venture in China, many foreign enterprises prefer to establish a representative office ("Rep Office" or "RO") over a wholly foreign owned enterprise ("WFOE"), since it is relatively easier and faster to set up a RO. In addition there is no minimum registered capital requirement for ROs. However, the Chinese government seems to cultivate a new climate for foreign investment by imposing much stricter regulations over Rep Offices. The following three regulations that were promulgated in 2010 reflect the government's policy trend.

I. Circular 4 and the New Registration Regulation

As a prelude, on January 4th, 2010 the State Administration of Industry and Commerce and the Ministry of Public Security jointly announced the *Notice on Further Strengthening the Registration Administration on Permanent Representative Offices of Foreign Enterprises* ("**Circular 4**"), which placed several strict rules for the operation of ROs in China, including but not limited to:

- A foreign company must have a 2-year history in order to establish a RO;
- A RO shall have no more than 4 representatives in China (including the chief representative).

As a year-end echo, on November 19th, 2010 the State Council published the revised *Regulation on the Administration of Registration of Permanent Representative Offices of Foreign Enterprises* ("Revised **Registration Regulation**"), which became effective on March 1st, 2011 and replaced the old one promulgated in 1983. Besides repeating the two major points stated in the preceding paragraph, some of other highlights of the Revised Registration Regulation are:

- A RO shall set up accounting books in accordance with PRC law;

- A RO can only carry out the following non-profit activities: (1) market research, exhibition and promotion activities related to the products and services of its foreign parent companies; and (2) liaison activities in connection with sales of products, provision of services, domestic procurements and onshore investment of its foreign parent companies;

- If a RO engages in any profit-making activities, the registration authority is entitled to confiscate all its illegal income and business-related properties, such as equipment and raw materials, impose a fine from RMB50,000 to RMB500,000, or revoke its registration certificate if the situation is serious. The amount of fine imposed by the old 1983 regulation is no more than RMB20,000.

II. New Tax Rule

On February 20th, 2010, the State Administration of Taxation released the *Provisional Measures on Tax Administration of Permanent Representative Offices of Foreign Enterprises* ("Circular 18").

Although the Revised Registration Regulation prohibits any profit-generating business of ROs, Circular 18 still presumes that Rep Offices in China are generating income and it aims to strengthen the tax control over Rep Offices. Accompanied by the invalidation of previous tax circulars that grant exemption for ROs under the old foreign enterprise income tax regime, one of the main focuses of Circular 18 is to set forth three methods to calculate the taxable income of Rep Offices for the purpose of collecting enterprise income tax ("EIT"):

- Financial record-based method

  According to Article 6 of Circular 18, Rep Offices with the ability to identify their expenses and revenues are required to set up accounting books and accurately calculate their taxable incomes "in proportion to functions performed and risks assumed by them". However, since implementing rules of Circular 18 are currently unavailable, it is yet to discover in the future practice how the tax authorities will define and classify the "functions" and "risks" of Rep Offices.

  Where a governing tax bureau finds that a Rep Office has no such ability to keep complete and accurate books, or file its tax liabilities on a financial-record basis, it will adopt one of the following two deemed methods. In either case Circular 18 raises the deemed profit rate applied by law from the previous 10% to a minimum of 15% (or more if it deems suitable).

- Deemed Profit Method - Based on Expenses

  If a Rep Office can calculate its expenses accurately, but not its revenue, the tax bureau will apply the deemed profit method to calculate the taxable income. The calculation formula is:
  Revenue = Expenses / (1 - deemed profit rate - business tax rate);
  Payable EIT = Revenue × deemed profit rate × EIT rate.

- Deemed Profit Method - Based on Revenue.

  If a Rep Office can only calculate its revenue accurately, but not its expenses, the tax bureau will apply the deemed profit method to calculate the taxable income. The calculation formula is:
  Payable EIT= Revenue × deemed profit rate × EIT rate.

III. Comparing Service WFOE and Rep Office

Generally speaking, a service WFOE is entitled to conduct the following functions that are not permitted by Rep Offices:

- Conduct profit-generating business activities;
- Recruit employees directly, rather than using government-designated HR agents;
- Set up board of directors to have better management;
- Establish branches in different locations of China;
- Assume limited liability;
- Expenses are generally deductible for EIT purposes.

Since a service WFOE can decrease its actual profit rate and taxable income by deducting expenses or making other proper tax arrangements, the actual tax burden of a service WFOE can often be lower than that of a Rep Office which applies deemed profit method.

With the above three regulations imposing more legal restrictions on Rep Offices, the Chinese government is signaling another attempt to limit the popularity of the Rep Offices structure. Thus, it is the time to reconsider your specific business requirements and whether a Rep Office is still the favorable structure for your business venture in China. Since 2010, we have also seen an increasing number of foreign enterprises that have already set up JVs, WFOEs or even a holding company in China have decided to close down their empty-shell ROs (substantive business already moved under JVs, WFOEs or the holding company) to avoid increased tax burdens due to their relatively large amount of expenses.

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