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Taxation of Permanent Establishment (PE) in China

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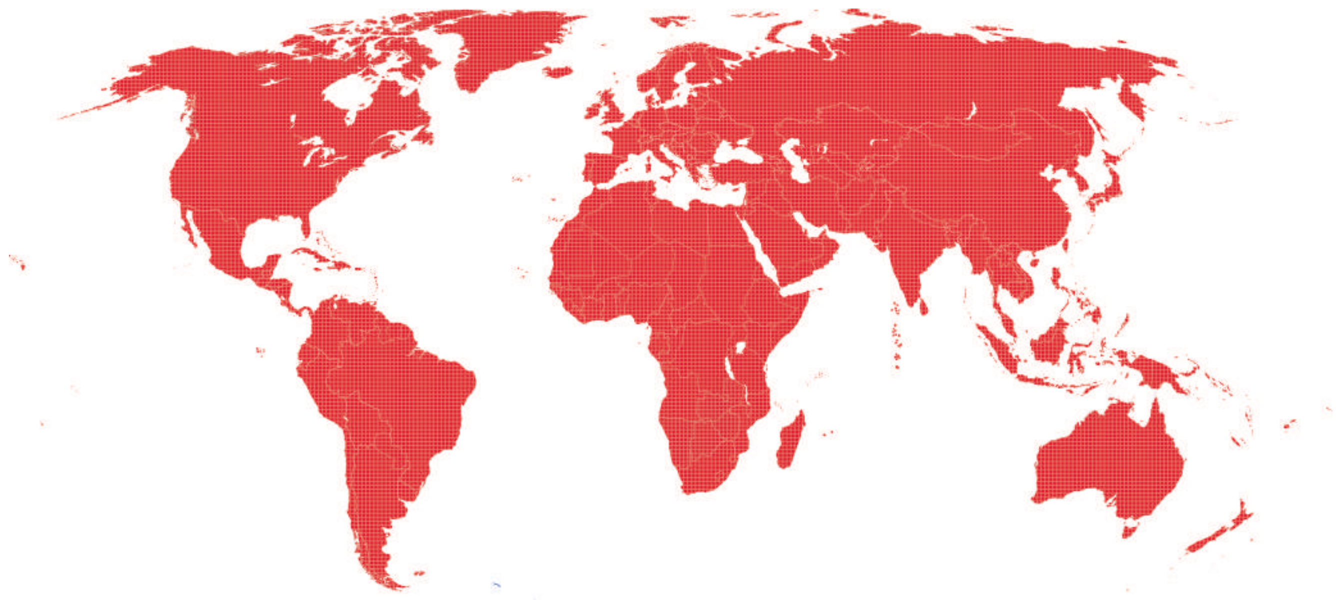

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1. Preface

In a simple analogy, permanent establishment (PE) happens when someone sells something overseas from his own country, and it entails some travelling there. The owner believes that the overseas income taxes are entirely irrelevant to him, because he never bothers to operate any formal establishment there – until the taxman overseas pops up to declare, “Sorry, you need to pay taxes here”.

When international trade is concerned, PE is one of the most common tax issues, but sarcastically also the mostly unnoticed by business operators, for various reasons. To a certain extent, this publication may get a few people doing cross-border deals in China worried. If so, this publication has achieved what it is supposed to achieve.

This publication aims at illustrating the practices and complexity of PE determination in China. It also provides an insight into how PE is affected by the “Base Erosion and Profit Shifting” (BEPS) initiatives in China.

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2.1 General introduction - what is PE?

2.1.1 Domestic law

PE is an international taxation arrangement provided in double taxation avoidance agreements (DTAs) of each country. By virtue of a DTA, a business can be taxed by a foreign country for the PE created. In such a case, DTAs will have prevalence over domestic tax laws of a country. Nevertheless, their interpretation and implementation may somewhat be affected by domestic tax laws in various degrees – therefore a source of complication and headache. It is a recurring challenge to explain in simple terms how PE is constituted in the business contexts, especially in an ever-developing tax legislation environment like China.

China's Corporate Income Tax (CIT) Law has distinguished tax resident enterprises (TREs) from non-tax resident enterprises (Non-TREs) [1].

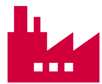
» A TRE is the one established per China or non-China laws, but has its place of effective management in China. Effective management in China is defined as an establishment that exercises, in substance, an overall management and control over an enterprise's business, personnel, accounting, and properties, etc. in China. A TRE shall pay CIT on its income derived from sources inside and outside China.

» A "Non-TRE", which has an establishment or a place in China shall pay CIT on its income derived from sources inside China as well as on income that, although derived from sources outside China, is effectively connected with such an establishment or a place. According to the wording of this law, the Chinese tax law does not require a "permanent establishment", but just an "establishment". Chinese tax law does not provide for a minimum requirement period of such "establishment".

An "establishment" or a "place" refers to a presence in China engaging in production or business operations, including[2]:

» management offices, business organizations and offices;

» factories, farms and premises where exploration of natural resources is carried out;



» premises where labor services are provided;

» premises where construction, installation, assembly, repair and survey projects etc. are carried out; and

» any other organizations engaging in production and business activities and any other premises where production and business activities are carried out.

It also includes any business agents engaged by a foreign enterprise (FE) to carry out production and business activities in China, including regularly signing contracts or storing and delivering goods on behalf of the foreign principal.

1. Article 2 (1), CIT Law 2007.
2. Article 5 (3), CIT DIR 2007.

2.1.2 Double Taxation Avoidance Agreements / Arrangements (DTAs)

As of the end of December 2015, China had concluded 101 DTAs, two tax arrangements and one tax agreement, covering almost all the important trading partners of China.

General DTA variation from OECD model

In general, China follows the principles of the OECD Model as well as the UN Model in defining "PE". According to Guoshuifa [2006] No.35 issued by China's State Administration of Taxation ("SAT"), "PE" refers to a fixed place of business through which the business of an enterprise is wholly or partly carried out. "PE" shall be deemed not to include the maintenance of a fixed place of business solely for the purpose of carrying out, for the enterprise, any activity of a preparatory or auxiliary character.

The term "business" does not only include production and operating activities, but also general business activities carried out by non-profit organizations. Accordingly, a non-profit organization which is engaged in Chinese business activities via a fixed place can also be deemed to constitute a PE in China, unless such an establishment carries out activities of a preparatory or auxiliary character.

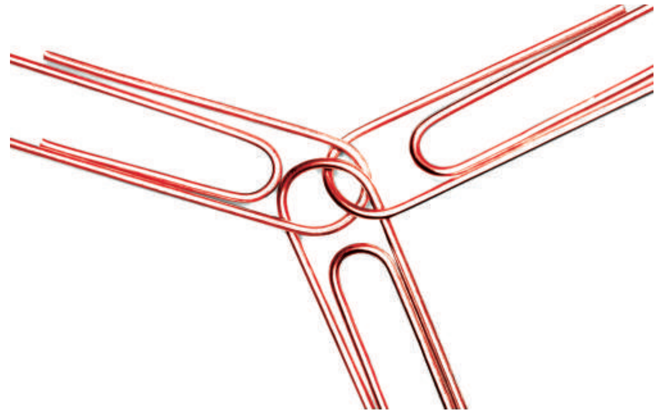
A "preparatory or auxiliary character" of activities is determined by the following principles:

a) Whether the fixed place provides services solely for the head office or whether it has business interactions with other parties;

b) Whether the nature of the business of the fixed place is consistent with the nature of the business of the head office; and

c) Whether the business activities of the fixed place constitute an important integral part of the business of the head office.

The question is if the fixed place not only provides services to the head office, but also has business interactions with other parties, or if the nature of the business of the fixed place is consistent with that of the head office and



its business forms an integral part of the head office's business, can the activities of the fixed place still be accepted as "preparatory or auxiliary character"? Likely not.

For example, an oil company exploring oil resources in China is often regarded as having a PE. A PE may also be deemed to exist, if an oil company from another contracting state has a place of management in China.

Notwithstanding the above, China has adopted a broader definition of PE than the one in the OECD Model. As a consequence, most DTAs concluded by China (except the China-UK DTA) have a PE definition which includes assembly and supervisory activities – in addition to building sites, construction or installation projects. A PE is created, if its activities last for more than 6 months[3], which is a shorter period than the 12-month period provided by the OECD Model Tax Treaty on Income and on Capital (article 5 [3]).

In line with the UN Model Treaty, the provision of services by an FE through its employees or other engaged personnel in China creates a PE if the duration exceeds 6 months in a 12 month period[4]. Some Chinese DTAs have an even broader PE definition which does also include an installation, a drilling rig, ship or structure used for the exploration or exploitation of natural resources for a period of more than 6 months in the definition of PE[5].

Based on the revised China-German DTA, and further updates to other DTAs with China, we see a general trend that, in most updated DTAs, the 183-day rule is adopted to determine service-related PEs, and 6 months for construction PE.

3. This period ranges from 6 months (e.g. China-US DTA) to 24 months (e.g. China-United Arab Emirates DTA).
4. Ditto.
5. This period ranges from one month (e.g. China-New Zealand DTA) to 12 months (e.g. China-Croatia DTA).

Specific DTA deviations from the OECD model

According to the OECD Model Convention, "PE" is defined as "a fixed place of business through which the business of an enterprise is wholly or partly carried on" in the DTAs concluded by China. It includes especially:

a) A place of management;

b) A branch;

c) An office;

d) A factory;

e) A workshop;

f) A mine, an oil or gas well, a quarry, or any other place of extraction of natural resources;

In the DTAs that China has concluded, there is no further definition on "a place of management", "a branch", "an office", "a factory", "a workshop" or "a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources".

In addition, certain DTAs of China carry a definition of "PE" which also includes:

g) A warehouse, related to a person providing storage facilities for others (China-Thailand DTA);

h) A farm or plantation (China-Malaysia DTA).

These items are not covered in the "PE" definition in the OECD Model.

Special cases

→ Service PE:

As mentioned above, China – like most other developing countries – follows the UN Model Treaty, which grants an extended right of taxation to the state in which a service is provided, i.e. extended taxation at source. The most relevant basis in this regard is section 3 (b), article 5 of the UN Model Treaty, in which the so-called service PE is determined.

A recent development indicates that the China tax authority has started assessing the economic substance of staff secondment arrangements. When economic substance is lacking, they will assume that the secondee is actually performing services in China for an FE and thereby creating a PE. The concept of "economic employer" is adopted in the assessment.

→ Agent PE:

If a Non-TRE commissions a business agent to carry out production and business activities in China, including commissioning an enterprise or an individual to regularly sign contracts, store and deliver goods, etc. on its behalf, such a business agent will be considered as the establishment or the place of the non-tax resident enterprise in China[6].

In a particular case (a.k.a. the San Rong case), a Hong Kong enterprise was engaged in the sales of equipment and the provision of technical services to customers in

6. Article 5, CIT DIR 2007.

China[7]. Its sales contracts with the Chinese customers are signed by its subsidiary in China, and the technical services are actually provided by its Chinese subsidiary. The Hong Kong enterprise was deemed as having a PE in China and all the profit related to this PE was subject to China CIT.

- Building site PE:

The DTAs of China specify that only a building site, construction, assembly or installation project, and supervisory activities in connection with a site or project lasting for a period of more than six months will be treated as a PE. In practice, the provisions are implemented in different ways depending on the situations as mentioned below:

a) Determination of starting / ending dates of a site or project or related supervisory activities.

b) Determination of starting / ending dates, if a company of the other state continually undertakes two or more projects at the same site or for the same construction task in China.

c) Treatment of temporary suspensions.

d) Determination of starting / ending dates, where a company of the other state is subcontracting a project to other enterprises.

Variations between local laws and tax treaties

China's CIT Law has a provision which stipulates that "where the provisions in tax treaties are different from the CIT Law, the provision in the tax treaties shall prevail"[8]. It does imply that if certain provisions are not addressed in the tax treaties, China's domestic laws should prevail. In other words, there will be situations that China's domestic laws have the final say.

7. Circular Guoshuihan [2006] No. 970.
8. Article 58, CIT law 2007.

2.2 Business trends – more PE formed in China

Strictly speaking, representative offices (ROs) are supposed to operate within a very limited scope of activities. In practice, ROs often exceed their official business scope and therefore technically create a PE. In February 2010, SAT released a set of measures for taxation of ROs and Non-TREs, which represent a drastic change to the previous tax regulations.

2.3 Tax administration trends – stricter and sophisticated administration in China

In the past, taxation of PEs in China used to differ in several ways from international practices. Firstly, China's definition of PE is relatively broader, both from a domestic perspective (e.g. no time limit vs. 6-month limit in most DTAs) as well as from a DTA perspective (e.g. application of service PE). Further, the taxation methods are unique and mostly not book-based, but based on deemed revenue / profit, leading to double taxation in some cases. And finally, a tax treaty is often overridden when ROs are involved.

In recent years, the Chinese tax authority has issued a number of regulations to strengthen the taxation administration on Non-TREs. Detailed compliance requirements are provided for Non-TREs in respect of tax registration and filings. Non-TREs are encouraged to file Chinese taxes based on actual profits rather than deemed profits, if accurate accounts are available and the actual profits of the PE in China should be commensurate with its functions and risks. These are efforts aimed at aligning with international practices.

Undoubtedly, the Chinese tax authorities are paying more attention on PE issues and are pooling resources in enforcing PE taxation, as evidenced by the steep rising of PE cases. However, despite the improving legislations, implementation variation still exists in practice.

Therefore, negotiation with the local tax bureau is still common in China because of rather extensively discretionary treatments by local tax authorities.

2.4 Regulation update in China

To strengthen tax administration on PEs, a series of tax legislations are issued, as listed below:

2.4.1 Legal provisions

» CIT Law of PRC (16 March 2007, Presidential Decree No. 63 of PRC)

» Implementation Regulations of CIT Law of PRC (6 December 2007, State Council Order [2007] No.512)

2.4.2 Administrative guidelines

» Request for Guidance Regarding Taxation Issues of Representative Offices of FEs Engaging in Commodity Exporting Trade (6 December 2005, Dongdishuifa [2005] No.178)

» SAT Circular on Issues Relevant to the Determination of PEs and Other Matters for the Purpose of Tax Treaties (14 March 2006, Guoshuifa [2006] No. 35)

» Provisional Measures of Tax Administration for Non-residents Engaged in Construction Projects and Provision of Services (effective 20 January 2009 SAT Order [2009] No.19)

» Provisional Measures for Tax Collection and Administration of representative offices of FEs (20 February 2010, Guoshuifa [2010] No. 18)

» Administrative Measures on CIT Collection of Non-TREs on a Deemed Profit Basis (20 February 2010, Guoshuifa [2010] No. 19)

» SAT Announcement on Issues Relating to Collection of CIT on Services Provided by Personnel Dispatched by Non-resident Enterprises within the Territory of China (19 April 2013, SAT Announcement [2013] No. 19)

2.4.3 Interpretation notices

» Official Reply from Minister of Finance (MOF) and the Offshore Petroleum Tax Bureau Regarding How to Count the Days for Residents from Other Contracting States Staying in China (10 December 1987, Caishuiyouzhengzi [1987] No. 26)

» SAT's Official Reply on the Determination of PE of Labour Dispatchment to Shenyang Aircraft Corporation for Technical Services Provided by McDonnell Douglas and Boeing (USA) (1 February 1999, Guoshuihan [1999] No.59)

» SAT's Official Reply on the Determination of PE of Labour Dispatchment to China by Hong Kong Leishe Semiconductor Device Co. Ltd. (16 July 2001, Guoshuihan [2001] No.550)

» SAT's Official Reply on the Determination of PE of the Supervisory Services Provided by Alstom (France) inside China (19 October 2004, Guoshuihan [2004] No.1168)

» SAT's Official Reply on Issues of Determining What Constitutes a PE of an FE Providing Services in China and the Attribution of the Profits (19 July 2006, Guoshuihan [2006] No.694)

» SAT's Official Reply on the Determination and Taxation of the PE of Hong Kong San Rong Automation Co. Ltd. in China (17 October 2006, Guoshuihan [2006] No.970)

3.1 Corporate Income Tax (CIT)

3.1.1 Determination of time threshold for PE constitution

As indicated in most of China's DTAs, "6 months" is usually adopted as the threshold to determine a PE constitution. As further interpreted by the tax circular, Guoshuifa [2010] No. 75, for a building site PE, "6 months" shall be calculated from the date when a project contract is implemented (including all preparation activities) to the date when all projects (including projects on trial operation) are concluded and delivered for use. If an operation has been postponed midway due to any reason, but the project has not been completed nor concluded, and the personnel, the equipment and the materials, etc. have not been withdrawn, the stoppage period shall still count without interruption and cannot be deducted from the period.

For a service PE, a China tax circular, Guoshuihan [2007] 403[9] (Circular 403), has rendered clarification on how to count a "month". It stipulates that the specific number of days should be disregarded in calculating a month. If an FE provides services for a certain project in China, the period from the month in which the first employee of that FE had arrived in China to provide services until the month in which the project is completed and the last employee of that enterprise has left China should be taken as the relevant period. If, during that period, no service was provided by the employees of that FE in China on that project for a period of 30 consecutive days, one month can be deducted. Based on this approach, the provision of services in China for only one day within one calendar month would be counted as "one month".

Although Circular 403 was originally introduced with regard to the China-Hong Kong DTA, it also states that its interpretation is applicable to other DTAs that China has concluded if the articles are the same and if no other interpretation has been provided.

Subsequent to Circular 403, the HK government and the Chinese government have signed a Second Protocol to the China-HK DTA which came into effect on 11 June 2008. Under the Second Protocol, the term "6 months" is now replaced by "183 days". Therefore, Circular 403's interpretation no longer applies to the China-HK DTA.

Consequently, the relevant article in explaining the "6 months" in Circular 403 is also cancelled. It thus results in some uncertainty in interpreting "6 months", which is still applicable to some other DTAs in their previous versions. Sufficient communication with the China tax authority is recommended with regard to the interpretation on the threshold for constituting a PE.

In a series of DTA updates by China with other counties, we see a trend that most updated DTAs (such as the China-Germany DTA) have adopted the 183-day rule for which the interpretation of Guoshuifa [2010] No. 75 can be used.

3.1.2 Determination of profit attributed to PE

CIT Law and implementation rule

- For investment into PRC:

  China CIT shall be payable by a non-resident enterprise, for income derived from or accruing in China by its office or premises established in China, and for income derived from or accruing outside China for which the established office or premises has a de facto relationship.

- For investment from PRC:

  Chinese tax resident enterprises with a foreign PE are liable to CIT in China in respect of their worldwide income[10].

9. "Issues Relevant to the Interpretation and Implementation of Articles of the China-Hong Kong DTA", 4 April 2007.
10. Article 3 (1), CIT Law 2007.

DTA and relevant interpretation

It is a general DTA provision that the profits of an enterprise of a contracting state shall be taxed only in that state unless the enterprise carries out business in the other state through a PE situated therein. If the enterprise carries out business as aforesaid, the profits of the enterprise can be taxed in the other state to the extent that they are attributable to that PE.

The China-Singapore DTA has not specified the method to calculate business profits but has stipulated some principles to be complied with in calculation, including the principle of independent enterprise, i.e. the PE is to be treated as an independent tax entity, no matter whether the PE engages in business transactions with its head office or with other PEs of the enterprise, the profit attributed to the PE shall be calculated based on the fair market price and in accordance with the arm's length principle.

3.1.3 Determination of taxable income

When calculating the profit of a PE, the expenses incurred by the PE can be deducted, no matter where they are incurred. They include expenses actually incurred by the PE but not directly realised, such as administrative and general management expenses apportioned by the head office to the PE. However, these expenses must be incurred by the PE and the ratio of apportionment should be reasonable. In actual implementation, enterprises should provide the information pertaining to the scope and the amount of expenses, the bases and the methods of apportionment, etc. in order to justify that the expenses are reasonable.

In normal circumstances, where the financial accounts of the PE can reflect its profit, the profit attributed to the PE can be calculated based on these accounts. However, in most cases, it is difficult to determine the profit attributed to the PE. Circular 75 specifies that where the profit of a PE cannot be determined from the accounts, the total profit of the enterprise may be apportioned based on a given formula to determine the profit attributed to the PE. There are differences between the outcome using this apportionment method and that using the financial accounts. The local tax authority governing the PE may also find it difficult to review the overseas profit of the FE or to the China PE profit determined either by the FE or by its overseas tax authority.

When a PE procures goods for an enterprise, the PE should not be deemed as deriving profits from the procurement activities and the profit derived from the procurement activities by the PE should not be calculated or determined pursuant to the method of profit attribution.

Once a certain method of profit apportionment is used, such a method cannot be changed even if the other method may give rise to a more favourable outcome. This provision is to ensure the continuity of tax treatments.

In general, for determining a taxable income, a PE is required to maintain accurate and complete financial accounts for arriving at an accurate profit amount. However, in practice, it is rare for an FE to set up accounting books for its PE in China and thus a PE is rarely taxed based on its actual profit. Therefore, to simplify the procedure, the Chinese tax authorities tend to apply Circular 19 to the taxation of a PE, meaning that if a PE is unable to compute its taxable income due to inaccurate or incomplete accounts or other reasons, its taxable income can be taxed using one of the following “deemed profit methods”.

Actual revenue deemed profit method

This method is used to determine the taxable income generated by the PE of a non-tax resident enterprise in China when a PE’s revenue can be ascertained but not its costs and expenditure. The formula for computing CIT is set out below:

CIT = Gross Revenue x Deemed Profit Rate x CIT Rate

In practice, this is the most popular method to calculate CIT for a PE.

Cost-plus method

This method is used when a PE’s cost cannot be measured by its income. This method is commonly used for trading agent PE. The formulas for calculating CIT are:

Gross Income = Cost / [1 - Deemed Profit Rate]

CIT = Gross Income x Deemed Profit Rate x CIT Rate

Expenditure-plus method

This method is used when a PE's expenses can be measured but not its revenue. The formulas for computing the CIT and BT amounts are set out below:

Gross Income = Expenditure / (1 – Deemed Profit Rate)

CIT = Gross Income x Deemed Profit Rate x CIT Rate

PEs adopting the cost-plus or expenses-plus method must accurately account for their costs / expenses in China, and be subject to a statutory audit.

The deemed profit rate to be applied to each method will vary according to the business nature of a PE, and will be determined by the local tax authority within the range of profit rates set by SAT, as indicated below:

Industry	Deemed profit rates
Construction projects, designing and consulting services income	15% - 30%
Management service income	30% - 50%
Other operating and service income	No less than 15%

When an FE provides services in China through its employees and constitutes a PE, the deemed profits of the PE will be taxed. As indicated above, SAT has provided a range of rather than a specific deemed profit rate and local tax authority is empowered to make its own selection on a profit rate within the range. In the lack of a clear guidance, the selection is largely based on the experience and assessment of the local tax authority.

In a case of a PE, FEs that sell machinery and equipment and, at the same time, provide services such as equipment installation, assembly, technical training, guidance and supervision, etc., are required to pay China taxes on the income from such services. If service charges are not expressly itemized in a sales contract, or the pricing is unreasonable, the tax authority can assess the value of its services and levy busubess tax ("BT"), or value-added tax ("VAT"), and CIT on the FE based on the assumption that the service income accounts for no less than 10% of the total contract value, according to a China tax circular, Guoshuifa [2010] No. 19.

3.1.4 Withholding / filing obligations

As stipulated in China's tax laws, a PE is subject to CIT, BT (or VAT) and individual income tax ("IIT"), and should file taxes to the local tax bureau. The Order of SAT No.19, published in 2009, addresses the procedures for a PE to meet the tax compliance. When a non-resident enterprise contracts engineering operation or provides services in China, it should, within 30 days after a project contract or an agreement being concluded, perform a tax registration with the tax authority in the place where the project is located.

However, it is practically a hassle for FEs to file a business and tax registration for their PEs in China, resulting in tax filing difficulty thereafter. Certain cities (e.g. Shenzhen) have laid out particular measures to tackle these procedural issues for PEs.

Considering that it will add extra administration burden to the local tax authority by making the tax registration mandatory before a PE is constituted (as no China taxes are due yet), some local tax authorities would agree to the delay of tax registration until a PE is constituted.

When an FE contracts an engineering operation or serves a project in China and has resulted in a PE, its CIT shall be paid in advance quarterly, and settled by the end of each calendar year, and finally cleared at the end of the engineer project or the service contract.

The filing periods for turnover taxes (BT or VAT) and IIT are different from that of CIT, as explained in the following sections.

3.2 Business Tax (BT)

3.2.1 BT taxable scope

Organisations and individuals engaging in provision of services, transfer of intangible assets or sale of immovables in China are BT taxpayers.

China is reforming its turnover tax system, which will result in Business Tax ("BT") being replaced by VAT. A few sectors which are still subject to BT in early 2016 has been subject to VAT since 1 May 2016. They are real estate and construction services, hospitality, food and beverage services, entertainment services, financial and insurance services.

The VAT reform will bring challenges and difficulty to PE taxation in China during the transitional period. Whether the services provided by the PE should be subject to BT or VAT is one of the major questions. Technically, the services provided before 1 May 2016 should still be subject to BT. However, when local BT filing systems are phased out, difficulty may occur to a PE trying to file BT.

3.2.2 Determination of taxable income for BT

The taxable income for BT shall be the total price and out-of-pocket expenses collected by the taxpayer for provision of taxable services, transfer of intangible assets or sale of immovables, except for the following circumstances:

a) The turnover amount of a taxpayer engaging in tourism business shall be the balance after deducting accommodation fees, meal expenses, transportation fees and ticket fees for tourist attractions paid for tourists to other organisations or individuals, and travel expenses paid to other tour operators for guiding tour groups from the total price and out-of-pocket expenses collected by the taxpayer;

b) The turnover amount of a taxpayer subcontracting a building project to other organisations shall be the balance after deducting subcontract fees paid to other organisations from the total price and out-of-pocket expenses collected by the taxpayer;

c) The turnover amount of a taxpayer engaging in buying and selling of financial products such as foreign currencies, securities, futures, etc. shall be the balance after deducting purchase price from sale price; and

d) Any other circumstances stipulated by the finance and tax authorities of the State Council.

"Out-of-pocket expenses" shall include the processing fees collected, subsidies, funds, fund-raising fees, repatriated profits, incentive fees, default penalties, late payment fines, deferred payment interests, compensation, monies collected on behalf, advanced monies, penalties and other out-of-pocket expenses of various nature, but shall exclude government funds or administrative charges collected on behalf which concurrently comply with the following criteria:

a) Government funds established with approval by the State Council or the Ministry of Finance, administrative charges approved by the State Council or the provincial People's Government and its finance and pricing authorities;

b) Financial receipts printed by the finance authorities at provincial level and above which are issued at the time of collection of fees; and

c) All funds collected but are required to be turned over fully to the treasury.

3.2.3 BT rates and VAT rates

The applicable BT rates and VAT rates are as follows:

Tax items	BT rates until 30 April 2016	VAT rates after 1 May 2016
Construction	3%	11%
Financial and insurance	5%	6%
Cultural and sports	3%	6%
Entertainment	5%–20%	6%
Servicing	5%	6%
Transfer of intangible assets	5%	6%
Sale of immovable	5%	11%

3.2.4 BT withholding / filing obligations

Where a non-resident has any taxable income under a BT regime, and has established an operation organization in China, it shall declare and pay BT by itself.

A non-resident shall fill in and submit the tax declaration form based on facts and the required materials, when carrying out tax declaration of BT.

The tax payment obligation for BT shall occur on the date on which a taxpayer has collected the business revenue or has obtained a proof of payment for its taxable services, transfer of intangible assets or sale of immovable.

3.3 Value-added Tax (VAT)

3.3.1 VAT taxable scope (taking into consideration the VAT reform)

Organisations and individuals engaging in sale of goods or provision of processing and repair services or importation of goods into China are taxpayers of VAT.

VAT applies in China to:

a) Sale and importation of goods;

b) Repair, replacement and processing services to goods;

c) Provision of modern services such as consulting, logistics, IT services, cultural and creative services, leasing of tangible movable property;

d) Transportation services; and

e) Postal and telecommunication services.

From 1 May 2016, VAT is extended to the remaining four sectors: construction, real estate, financial services and lifestyle services. Since then, VAT has covered all industries in China.

3.3.2 Determination of taxable income for VAT

The taxable income amount shall be the total price and out-of-pocket expenses collected from the buyer by a taxpayer engaging in goods sold or taxable labor services.

3.3.3 VAT rate

The applicable VAT rates are as follows:

Tax items	Tax rates
Sale and importation of goods	Mostly 17% (13% for specific daily life and agricultural items)
Repair, replacement and processing services to goods	17%
Leasing of tangible movable property	17%
Part of modern services	6%
Transportation services	11%
Postal services	11%
Basic telecommunication services	11%
Value-added telecommunication services	6%
Services that will be subject to VAT since 1 May 2016	Construction, real estate, financial services and lifestyle services

A business involves goods or taxable services governed by different VAT rates should carry out separate accounting for them; otherwise, the highest VAT rate among them will apply.

For a China-registered company, depending on its revenue or the status of its accounting books, they are classified into two VAT payer categories: a general VAT payer and a small-scale VAT payer.

» A general VAT payer is subject to the above mentioned VAT rate, i.e. 6%, 11%, or 17% depending on the nature of the transactions.

» A small-scale VAT payer shall be subject to a flat rate at 3% on the net turnover amount.

How the above mentioned two treatments for VAT rate can be applied to a PE is still controversial. Specifically, a PE is commonly adopting the deemed profit method to calculate relevant taxes in China. It can hardly record its costs and expenses, let alone its input VAT for a general VAT payer consideration. In this regard, it is very difficult and practically infeasible for a PE to be recognized as a general VAT payer.

When no PE is constituted, an applicable VAT rate rather than a flat VAT rate should apply, to be withheld by the Chinese customers; if a PE is registered as a small-scale VAT payer, in theory the flat VAT rate should apply. However, some local tax authorities in China will disallow a PE being recognized as a small-scale VAT payer, and still require the PE to adopt the applicable VAT rate as a general VAT payer. Furthermore, in the application of the official online VAT system (called the golden tax system) in China, certain taxpayers have no choice but to be recognized as a general VAT payer once their annual turnover have exceeded certain threshold. Despite its general VAT status, worse still, it is practically not feasible for a PE to issue VAT invoices or claiming input VAT credits as a PE is not recognised as an entity for such purposes.

Given the above mentioned uncertainty, communication and negotiation with the tax authorities in charge is commonplace where VATs are concerned with PEs.

3.3.4 VAT withholding / filing obligations

Where a non-resident has a taxable behavior under the VAT regime, and has established an operation organization in China, it shall declare and pay VAT by itself.

A non-resident shall fill in and submit the tax declaration form based on facts and the required materials, when carrying out tax declaration of VAT.

For sale of goods or provision of taxable labor services, VAT obligation shall occur on the date when the sales proceed is collected or the proof of sales proceed is obtained. However, if a VAT invoice is issued upfront, VAT obligation shall occur on the date when the VAT invoice is issued.

3.4 Individual Income Tax (IIT)

3.4.1 IIT taxable income and calculation method

Foreign employees of a non-resident company working for the PE have to pay IIT from their first working day in China for the PE regardless of how long they have worked in China. The expatriate who provides onshore services should be included even if the duration of their stay is very short. Depending on the length of the working period of an expatriate in China, different calculation methods should apply, as listed below:

a) If an expatriate has stayed in China for no more than 183 days, IIT is calculated as follows:

   IIT = (amount of taxable income from salary of the month paid inside and outside China x applicable tax rate – quick calculation deduction) x (salary of the month paid within China / Total amount of salary of the month paid inside and outside China) x (working days within China/days of the month)

   However, per the tax circular, Guoshuifa [1994] No. 148, if the expatriate is working for a PE in China which does not have any income subject to CIT or is subject to CIT on a deemed profit rate basis, the income derived from the expatriate's working period in China shall be deemed to be borne by that PE, regardless of whether or not the expenses are actually booked by PE or not. Therefore, IIT is calculated as follow:

   IIT = (amount of taxable income from salary of the month paid inside and outside China x applicable tax rate – quick calculation deduction) x (working days within China/days of the month)

b) If an expatriate works in China for more than 183 days but less than one year, IIT is calculated as follows:

   IIT = (amount of taxable income from salary of the month paid inside and outside China x applicable tax rate – quick calculation deduction) x (working days within China/days of the month)

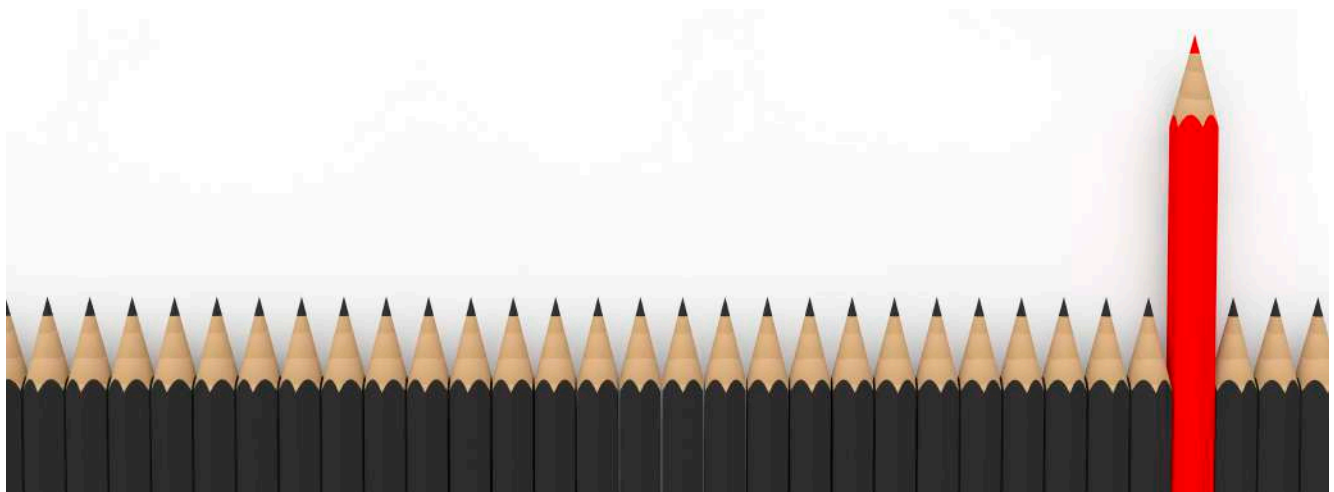
c) If an expatriate has stayed in China for more than one year but has no residence or he is directorship or senior management personnel:

   IIT = (amount of taxable income from salary of the month paid inside and outside China x applicable tax rate – quick calculation deduction) x [1 - (salary of the month paid outside China / Total amount of salary of the month paid inside and outside China) x (working days outside China/ days of the month)]

d) If an expatriate has stayed more than 5 years in China and is considered a Chinese tax resident, he is subject to China IIT on his global income.

   In calculating IIT, a monthly allowance deduction of CNY 4,800 is granted to all foreign employees. And the PE should be the IIT withholding agent for its employees in China.

There are cases where expatriates are assigned to China before or during a project, for business meetings, project supervision, project preparation or status evaluation. The assignment period is usually short, and the assigned personnel are usually non-operational staff. It raises the question that whether such personnel should also be subject to China IIT as soon as they arrive in China. Technically speaking, the period from the preparation



of the project to the final conclusion of the project shall be counted as a whole for PE consideration. However, regarding what kind of work shall be included in the preparation or conclusion of the project, the regulation has not clearly defined and it requires a judgment and negotiation on a case-by-case basis.

IIT rate

In China, salaries and wages are subject to progressive IIT rates as follows:

Level	Monthly taxable income	IIT rate	Quick deduction
1	If not exceeding CNY 1, 500	3%	0
2	For the part exceeding CNY 1, 500 but no more than CNY4, 500	10%	105
3	For the part exceeding CNY 4, 500 but no more than CNY 9, 000	20%	555
4	For the part exceeding CNY 9, 000 but no more than CNY 35, 000	25%	1,005
5	For the part exceeding CNY 35, 000 but no more than CNY 55, 000	30%	2,755
6	For the part exceeding CNY 55, 000 but no more than CNY 80, 000	35%	5,505
7	For the part exceeding CNY 80, 000	45%	13,505

3.4.2 IIT withholding / filing obligations

A PE has the obligation to withhold IIT for the employees of the foreign company who provide onsite services in China. IIT shall be filed in China monthly.

In practice, it poses a logistic difficulty for a PE to withhold IIT for its foreign employees in China. Thus, it is common to have the foreign employees filing their IIT by themselves or via a tax agent in China.

3.5 Stamp Duty (SD)

3.5.1 SD taxable income

SD can also be triggered in PE situations, depending on the types of documents, including contracts of purchases and sales, processing, contracting for construction projects, commodity transportation, warehousing, technology, etc. The contract value shall be the tax base to calculate SD.

3.5.2 SD rate

The SD rates for taxable documents are as follows:

Taxable vouchers	SD rates
Purchase and sale contracts	0.03%
Processing project contracts	0.05%
Construction project surveyance and design contracts	0.05%
Construction and installation contracts	0.03%
Commodity transportation contracts	0.05%
Storage and custody contracts	0.01%
Technology contracts	0.03%
Property transfer contracts	0.005%

3.5.3 SD withholding / filing obligations

The foreign company shall file the SD by itself. It shall fill in and submit the tax declaration form based on facts and the required materials, when carrying out SD declaration.

4.1 Tax registration

4.1.1 Would a PE be constituted in other cases?

In some cases, PEs are triggered by a representative office ("RO").

In some other cases, PEs are triggered by a foreign service provider. When the onsite activities carried out by an FE has exceeded the timing threshold set by the relevant DTA, PE is then constituted. However, local tax bureaus in China often have different practices to determine whether the timing threshold of PE is met. Sometimes there is a room to argue with the tax bureau about the PE constitution.

4.1.2 Where should a PE be registered?

For PEs due to ROs, they are already registered with the relevant local Administrative Bureau of Industry and Commerce ("AIC") and a local tax bureau. Hence, these PEs can file their tax returns locally in its own name for the income attributable to the PE.

For PEs that are triggered by a foreign service provider, they shall conduct a tax registration with the local tax bureau at the location where the PE is constituted.

FEs may in some cases have difficulty in registering with the local tax bureau due to various technical reasons. Some PEs even have multiple operation locations for onsite services in which case it is hard to decide where to have the tax registration done. Reconciliation with the tax offices concerned is necessary then.

4.1.3 When should a PE be registered?

When an FE conducts an engineering operation or provides services in China, it shall, within 30 days after a project agreement (hereinafter referred to as the contract) being concluded, perform taxation registration with the tax authority in the place where the project is located. If the due date of registration is missed, the tax bureau in charge is entitled to collect penalty fines.

However in practice, few FEs can manage to file the tax registration within 30 days upon the conclusion of a contract. It is possible to negotiate with the tax bureau on a practical timeline for tax registration.

4.1.4 How should a PE be registered?

To perform PE registration, an FE with a PE in China should submit the application documents to the tax authority in charge. Documentation requirements do vary from place to place.

As a PE is not regarded as a legal entity in China, it is not required to have a legal representative appointment. However, a responsible person should be appointed for the PE to execute the documents required by the tax authority on behalf of the FE.

Before tax registration, a deemed profit rate should also be negotiated and fixed with the state tax bureau in charge. In practice, the local tax authority will likely adopt the deemed profit method for CIT filings. The determination of the deemed profit rate is still not a well-regulated practice. In general, the tax authority will conduct a preliminary assessment of the deemed profit rate after reviewing the relevant contracts. Negotiation with the tax authority should be arranged promptly to argue for a reasonable deemed profit rate. Most tax bureaus tend to adopt the highest deemed profit rate in a SAT-given range, e.g. 30% for consulting services, which is beyond a realistic profit rate as one can recognize. It is thus crucial to negotiate with the tax bureau in advance for an acceptable treatment.

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4.2 Regular tax filing

After the tax registration, CIT, VAT / BT, SD as well as IIT filing shall be conducted.

CIT is filed on a quarterly basis whereas VAT / BT and surcharges are filed on a monthly basis. In practice, it is possible to file taxes each time when a contractual payment is received from the Chinese customers, subject to the consent of the tax authority in charge.

SD should be filed when it occurs.

In addition, as mentioned before, PE shall withhold IIT for the employees. Generally, IIT filings shall be conducted on a monthly basis.

Receiving tax payments from abroad is often an issue for a local Chinese tax bureau which has no foreign currency bank account. In this case, assistance from a tax agent will be necessary.

4.3 Annual CIT filing and annual IIT filing

An annual CIT filing should also be conducted for a PE. However, in practice, the implementation may vary and require clarification with the tax authority in each case.

Furthermore, any individual who has an annual income of more than RMB 120,000 is also required to file an annual IIT return. However, the said individuals do not include individuals who have no domicile in China or who have stayed in the territory of China for less than one year in a tax calendar year. Therefore, the employees working for the PE, who have been outside of China for more than 30 days consecutively or more than 90 days accumulatively in a calendar year, can be exempted from the annual IIT filing obligation.

4.4 Tax de-registration

It is required that an FE shall, within 15 days upon the completion of the services provided within the PE, apply for tax de-registration with the tax authority in charge. It is required to confirm that the project is completed and accepted by the customers in China. The tax registration certificate of the PE will be cancelled after de-registration is done.

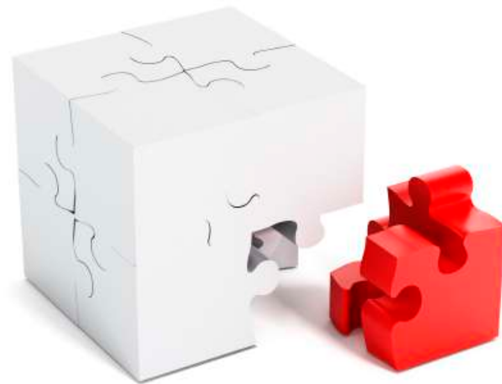
5.1 Construction PE or service PE?

A French company ("Company A") has concluded a service contract with a Chinese company ("Company B"). To carry out its contractual obligation, Company A has dispatched its employees to provide supervision services at the site of Company B. The service period has lasted for more than 6 months within a twelve-month period.

The Chinese tax bureau held the opinion that the service provided by Company A was related to a construction project and the services were mainly for supervisory and advisory purpose. Therefore, it concluded that a construction PE threshold should be adopted, i.e. 6 months, to assess if a PE is constituted. Based on this threshold, a PE is constituted in China. However, Company A took a different view and believed that the service-PE threshold should apply and it decided not to conduct any tax registration or filing procedure, which were later subject to a fine by the local tax authority.

It is common that when it comes to interpretation of PEs and the threshold, different tax authorities hold different views and negotiation will be necessary.

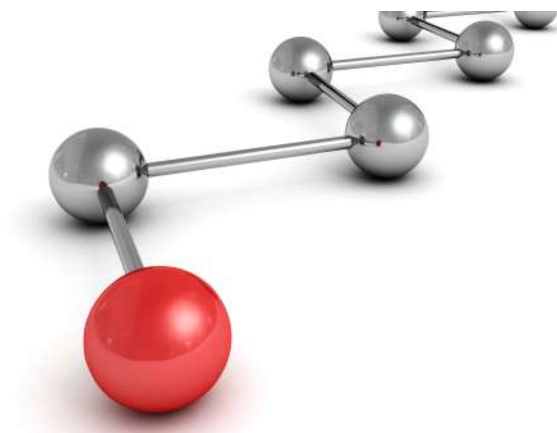
5.2 Should a whole consortium or an individual member be considered for PE constitution?



Several German companies have registered a consortium for VAT purposes in Germany, which has concluded an engineering contract with a Chinese customer. According to the contract, the German consortium will send their employees to China to provide onsite services.

When considering the PE constitution status in China, it is not clear under the current China legislation whether the consortium should be considered as an integrated party, or as individual members separately. By making reference to a China tax circular, (Guoshuifa [2010] No. 75), which is a general interpretation on all DTAs of China, usually one enterprise (= one legal entity) is considered in one PE case (except for some subcontractor's consideration). The Chinese tax authority in this case has adhered to the principle of substance over form, and considered that the consortium members have constituted one PE collectively in China and thus should be subject to relevant taxes in China accordingly.

5.3 Agent PE



A holding company in Hong Kong ("Company E") has set up a subsidiary ("Company F") in 2006 in Dandong, China (close to the border of North Korea where it has investment)

In 2007, Company E and F signed an entrustment agreement, according to which, Company F acted as the agent of Company E for project planning, equipment installation and production in North Korea, and for marketing and sales in China. Company E agreed to pay an agent fee to Company F based on its turnover.

The Chinese tax bureau in charge has taken the view that Company F was entrusted by Company E to sign frequently the sales contracts with the Chinese customers on behalf of Company E. Besides, Company F was working as Company E's agent and such agency business was its sole business. The tax bureau viewed that Company F should be deemed as an establishment or a place of Company E in China, and has constituted a PE of Company E in China. Therefore, all the incomes attributable to the PE in China should be subject to CIT.

Agent PEs used to be less common due to recognition difficulty. In recent years, it is observed that international tax trends are closely adhered to and more agent PE cases are set up in China.

6. Glossary of terms

BT	Business Tax
CIT	Corporate Income Tax
CNY	Chinese Yuan
DTA	Double Tax Agreement / Arrangement
FE	Foreign Enterprise
HK	Hong Kong Special Administration Region
IIT	Individual Income Tax
MOF	Ministry of Finance of China
OECD	Organizaiton for Economic Co-operation and Development
PRC	People's Republic of China
SAFE	State Administration of Foreign Exchange of China
SAT	State Administration of Taxation of China
SD	Stamp Duty
TRE	Tax Resident Enterprise
UN	United Nations
VAT	Value Added Tax
WFOE	Wholly Foreign-Owned Enterprise
WHT	Withholding Tax

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