Recent developments applicable to non-resident service providers with clients in the People's Republic of China

In Brief

The People's Republic of China has issued two circulars providing detailed compliance requirements aimed at reaching foreign service providers with clients in China. These new provisions will have a far reaching impact upon some foreign law firms, including the possibility of double taxation.

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A. New Requirements for Paying BT and CIT Released

The Chinese State Administration of Taxation ("SAT") recently released two circulars that set forth detailed compliance requirements for non-resident contractors/service providers providing services within China:

(1) Provisional Measures of Tax Administration for Non-residents Engaged in Contracting Projects and Provision of Services (SAT Order [2009] No. 19); and,

(2) Notice Regarding Publication of the Administrative Measures of Annual CIT Filing for Non-resident Enterprises (Circular GuoShuiFa [2009] No. 6).

Our colleagues at PricewaterhouseCoopers China anticipate that the new requirements will have a significant procedural and economic impact on non-resident contractors/service providers and their Chinese project owners/service recipients.

1. Administrative Requirements

Under Order 19, both the non-resident service providers and the Chinese service recipients (normally, the withholding agent) are required to register their service contracts with the local tax authorities within 30 days after the contract is concluded. Discussions with SAT officials indicate that the registration by non-resident service providers could be exempt where all services are provided outside China, but this has not been formally acknowledged by SAT.

In the past, the local tax authorities were probably not aware of service contracts concluded between the non-resident service providers and Chinese service recipients unless tax certificates were required to be submitted by the Chinese client for foreign exchange remittance purposes. Thus, the local tax authorities were not aware when service fees were settled offshore. Now, due to the various filing obligations imposed by Order 19, the local tax authorities can easily track down the taxation status of each service contract (even if the service fees are paid offshore) and they may either require the non-resident service providers or the Chinese service recipients to take appropriate actions in reporting the project and relevant taxes.

2. Potential Double Taxation in the Case of Joint Services

Essentially, the new circulars have not only created more administrative burden for the non-resident service providers and the Chinese service recipients, but they may also result in further tax inefficiencies or double taxation. For instance, if the head office of a U.S. multinational law firm located in the United States contracts with a Chinese client and provides services jointly with its Beijing office, Order 19 requires the head office to register the contract and perform tax filings -- Corporate Income Tax "CIT" and Business Tax "BT" -- with the local tax bureau “where the project is located.” The U.S. head office may choose to designate the Chinese client as its withholding agent in lieu of performing its own registration and filings.

In this example, the overall BT burden on the U.S. multinational firm for the project should comprise: (1) 5% on 100% of the U.S. head office’s fees receivable from the client, as a result of the new BT regulation, regardless of where the services are provided; and (2) 5% on the allocated revenue reported by the firm's Beijing office in relation to their efforts on this project. This will result in double taxation with respect to the BT on the portion of revenue allocated to the Beijing office. It may be worthwhile to consider issuing separate bills from the U.S. head office and the Beijing office to minimize the BT.

With respect to CIT, the head office should consider negotiating with the local tax authority at the project location for a favorable income tax computation and settlement method (for example, a favorable deemed profit rate or tax based on actual profit). It is important to note that Chinese clients would normally not bother to obtain favorable computations from the tax authorities on behalf of the non-resident service providers, if they are designated as withholding agents.

3. Circular 82 and Order 19: Conflicts or not?

The differences between the requirements listed in Circular 82 and Order 19, which are both applicable to foreign law firm's operations in China, are clear. Using the example from above, according to Circular 82, in the case of joint services the U.S. multinational firm's overseas (ex-China) office's revenue should be combined with the Beijing Office's and included in taxes reported by the Beijing Office. However, according to Order 19, the overseas office should report taxes to the in-charge tax authority "where the project is located"; here, the Chinese client's location.

Thus, each of the two regulations calls for taxes to be reported to a different location. While the Beijing tax authority still follows the principles of Circular 82 in determining the CIT of the Beijing Office, many problems arise in relation to the taxation jurisdiction, tax clearance certificate issuances, etc.

PricewaterhouseCoopers China has notified the Beijing State Tax Bureau (Municipal level) ("BSTB") International Tax Division of this conflict. The BSTB is preparing a tax circular regarding implementation of Order19 in Beijing. Hopefully, this issue will be addressed.

Another important inconsistency arises in connection with Order 19. It states that when a project in China is located in a different location from the foreign enterprise's China establishment (i.e., the Beijing Office in our example), the in-charge tax authorities of these two locations should communicate to resolve disputes, if any. In Beijing, a taxpayer should be able to seek assistance from the tax authority at the municipal level to coordinate and resolve differences among the tax authorities of the different districts. However, from a practical standpoint, this process may be quite time consuming, and cross-province communication among the tax authorities would likely lead to further issues and delays.

There are still uncertainties with the application of the new circulars, and the local tax authorities are working on their own versions of local implementation rules. PricewaterhouseCoopers China is advising its multinational law firm clients to check with the relevant local tax authorities on the local practice of implementing Order 19 before concluding any contracts with Chinese clients.

B. Transfer Pricing Documentation Requirements

Recently, the Chinese SAT issued Circular GuoShuiFa [2009] No. 2, which requires enterprises doing business in China to have relevant transfer pricing documentation ("TPD") for each tax year in place by May 31 of the following year. TPD must be in Chinese and must be presented within 20 days of receiving a

request by the tax authority. The due date for compiling the 2008 TPD has been extended to December 31, 2009 since this is the first year.

Failure to submit TPD upon request gives the Chinese tax authority the power to deem the amount of the entity's taxable income, and to assess a five percent "penalty" component (*in addition to* a "financial" component that is based on the normal People's Bank of China lending rate) as part of the "interest levy" on any special tax adjustments made by the tax authorities.

Enterprises are exempt from TPD requirements if they meet certain criteria. Service providers are exempt if the annual amount of related party transactions (other than transactions involving the purchase and sale of tangible goods) do not exceed RMB 40 million in a tax year.

The Chinese tax authorities treat the Chinese branch of a foreign organization as a related party to its head office, thus the TPD requirements apply. PwC China has held several meetings with the Beijing tax authorities in an attempt to learn whether the Chinese office of a foreign law firm is subject to the TPD requirements and, if so, whether the following activities may be deemed related party transactions to which TPD requirements apply:

(1) Revenue allocations to the China office where services are provided jointly with an overseas office; and,

(2) Overhead allocations from the head office.

PricewaterhouseCoopers China has confirmed with officials of the BSTB International Tax Division that the TPD requirements apply to the Beijing offices of foreign law firms because they operate similar to a branch and are taxed on their actual profits. Therefore, both of the scenarios above should be regarded as related party transactions. The view of the BSTB International Tax Division officials is that the foreign head office has certain control over the allocations, therefore the China tax revenue is at risk. TPD should be available to support that the allocations have been determined on an arm's-length basis. PwC China has suggested that the BSTB International Tax Division seek guidance from the SAT's International Tax Department. Meanwhile, representative offices of foreign law firms should assume that TPD requirements apply in Beijing, unless an exemption applies.

As discussed above, there is a RMB40 million threshold for exemption from TPD for a given tax year. Since Circular 82 has not been abolished for CIT purposes, PwC China has been advising clients that the exemption assessment should be performed in accordance with the 60/40 and/or 80/20 allocation rules set forth in Circular 82.

If the TPD requirements do apply, it should not be a complicated exercise to prepare the documentation. For revenue allocations where services are provided jointly by a firm's foreign office and the China office, generally the charging basis would be hourly rates and actual time cost incurred by the China Office. A solid TPD base could be created using internal records (e.g. time sheets). For overhead allocations charged by the head office, several multinational law firms have relied upon internal firm policies, functional analysis and spreadsheets to evidence the arm's length basis of the charges.

Conclusion

The change in requirements for paying China's BT and CIT will increase the level of complexity involved in the payment of Chinese taxes by multinational law firms with clients in China. Similarly, China's new TPD requirements present an additional burden for firms that routinely provide services to clients located in China. However, with the right level of planning, neither of these changes should present a problem.

PricewaterhouseCoopers' worldwide team of professionals has extensive experience assisting our clients with these issues. If we can assist your firm, please contact Stanley Kolodziejczak at 646-471-3160, Gregg Sincoff at 646-471-1335, or Nancy Regan at 646-471-6104.

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