Tax Residency of Companies in China

by *Shiye Yuan*, Han Kun Law Offices

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A Practice Note setting out when a company is subject to Chinese corporate income tax. It also discusses when a non-China resident company has a permanent establishment (PE) in China and how PEs are taxed under Chinese law. It also describes how the right to tax a company's profit may be allocated under a double tax treaty if a company is tax resident in two jurisdictions.

This Note describes the cases where resident and non-resident companies must pay Chinese corporate income tax. It also describes how the right to tax a company's profits may be allocated between different jurisdictions under a double tax treaty in case of double residence.

Basis of Taxation: Tax Residence

In broad terms Chinese corporate income tax applies to:

- Companies resident in China for tax purposes (which broadly includes companies incorporated in China and foreign companies which have a place of effective management in China).
- Non-resident companies which have an office or establishment in China and derive China-sourced income and non-China-sourced income through the office or establishment. An "office or establishment" is a domestic concept similar to that of a permanent establishment (PE, see *Permanent Establishment*) under Double Taxation Agreements (DTAs).
- Non-resident companies which do not have an office or establishment in China but derive source income from China (see *Non-Resident Companies with China-Sourced Income*).

Tax Residence Under Chinese Law

A company is considered tax resident in China if any of the following applies:

- It is incorporated under Chinese law.
- Its place of effective management is located in China (see *Place of Effective Management of Foreign Companies*).

(Article 2, *Corporate Income Tax Act*.)

Place of Effective Management of Foreign Companies

A "place of effective management" refers to where the management of a company (for example, its board of directors) conducts substantial and overall management and control of the company's production, operations, personnel, finance, property, and so on (article 4, Regulation on the Implementation of the Enterprise Income Tax Law of the People's Republic of China (*Implementation Regulation*)). A Chinese-controlled foreign company should be regarded as a Chinese resident company when its place of effective management is established in China.

Generally, the following criteria determine the place of effective management of a foreign company:

- The company's senior management responsible for the routine business management perform their functions mainly in China. For instance, directors of a Chinese company need to be physically located in China.
- Finance-related decisions and personnel-related decisions (for example, hiring, salary increase, bonus payments, and so on) are made by or are subject to the approval of the human resources team located in China.
- The major properties (including real estate and moveable assets, such as machinery and equipment), accounting books, company seals, and minutes and archives of the meetings of the board of directors and shareholders, and so on are located or preserved in China.

- At least half of the directors with voting rights or the senior management personnel customarily reside in China.

(Article 2, *Notice of the State Administration of Taxation on Issues about the Determination of Chinese-Controlled Enterprises Registered Abroad as Resident Enterprises on the Basis of Their Body of Actual Management*.)

Taxation of Chinese Tax Resident Companies

Taxable Base

The taxable income is calculated in accordance with the profit and loss account results and considering certain tax adjustments. For example, certain expenses such as entertainment expenses are not allowed for a full deduction, or some revenue (such as state bond revenue) is free from taxation.

Special Adjustments to Tax Profits

Under the controlled foreign company (CFC) rules, profits realised by a Chinese controlled foreign subsidiary that benefit from a low-tax regime are taxable in the hands of the Chinese parent company.

The CFC rules prevent the artificial shift of profits from China to low-tax jurisdictions. A country has a low-tax regime if the profits attributable to the Chinese parent company are not taxed or are taxed at a level that is 50% lower than the taxation which would apply if the profits were taxed in China.

The Chinese corporate shareholders are requested to provide foreign investment information (such as target company information, shareholder information, and shareholder change information) when filing annual income tax returns. Failure to provide this information may trigger an investigation from the tax bureau and a tax fine. Undistributed or reduced distribution of profits of the foreign subsidiaries, which do not result from reasonable operational needs, could trigger application of the CFC rules.

Tax Rates

The tax rates vary depending on the nature of the entity.

Chinese corporate income tax is applied at a standard rate of 25%, while the applicable tax rate for income sourced in China of non-resident companies shall be 10%.

A reduced corporate income tax rate may apply in certain circumstances, for example:

- Qualified small low-profit companies: 20%. Further, small low-profit companies calculate taxable income at a reduced rate, which could bring the effective tax rate to 5% or lower, depending on the policy effective in the specific year.
- Key advanced and new technology enterprises whose industry is supported by the state: 15%.
- Foreign companies that do not have PE in China but source income from China: 20%. This further reduces to 10% according to existing regulations.

(Articles 4 and 28, Corporate Income Tax Act; Article 91, Implementation Regulation.)

Dual Tax Residence

Dual tax residence may occur where a company resident in China is also considered resident in another jurisdiction due to the local rules. For example, a company incorporated in China which has its effective place of management in a different country may be considered resident in both China and the other country.

Double tax residence may lead to double taxation of the same profits.

Domestic law and DTAs aim to prevent or solve this double taxation issue.

Double Tax Treaty Protection

In the case of dual tax residence, the country of tax residence is determined by the DTA existing between China and the other country.

It is necessary to look at the relevant DTA for the terms of the tie-breaker rule (that is the rule of the DTA determining which of the two countries is the country of tax residence where the company will pay corporate income taxes).

China has entered into a network of DTAs with over 100 jurisdictions. DTAs are largely based on the Organisation for Economic Co-operation and Development (OECD) *Model Tax Treaty on Income and on Capital 2017* (OECD Model Tax Treaty) *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI)*and the *United Nations Model Double Taxation Convention between Developed Developing Countries 2017* (UN Model Tax Treaty), two standard forms that many countries use as a starting point when negotiating a DTA.

A general overview of how the issue of dual tax residence is typically dealt with based on the OECD Model Tax Treaty and the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (MLI) is set out in the following sections.

OECD Model Tax Treaty

The OECD Model Tax Treaty states that a company is resident in a country if it is liable for tax in that country by reason of its domicile, residence, place of management, or any other criterion of a similar nature (article 4).

Before being amended by the MLI, it also provided that, should a company be resident in two countries, it should be treated as resident in the jurisdiction of its place of effective management (article 4(3)). This is the place where key management and commercial decisions that are necessary for the conduct of the company's business as a whole are made. To determine this, all relevant factual circumstances must be examined.

Determining where a company is effectively managed may be difficult, given that senior directors are often highly mobile individuals and meetings are often carried out and decisions adopted through electronic communication.

Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI)

The MLI is a multilateral treaty signed by more than 95 countries that amends and supplements existing DTAs with various anti-abuse provisions, depending on the elections made by the signatories. The MLI was published on 24 November 2016 (see *Legal*

Update, OECD publishes multilateral instrument on BEPS (detailed update)). It was opened for signature on 31 December 2016. For further information, see *Practice Note, OECD multilateral instrument on BEPS*.

China is a party to the MLI. The MLI entered into force for China from 1 September 2022.

Article 4 of the MLI changes the tie-breaker for dual resident companies. It provides that the place of residence of a company resident in both countries is to be determined by the competent authorities of both countries by mutual agreement, taking into account:

- The place of effective management.
- The place where the company is incorporated.
- Any other relevant factors.

For jurisdictions for which mutual agreement procedures apply, a company is considered dual resident until the competent authorities reach an agreement.

No Double Tax Treaty Protection

Where there is no applicable DTA, a company may be resident in both China and another jurisdiction. The company is therefore subject to the tax laws of the other jurisdiction as well as to Chinese tax on its worldwide profits. It may be taxed twice on some or all of its profits.

To mitigate double taxation, the Corporate Income Tax Act adopted a foreign tax credit rule. A company may use income tax it has paid overseas on certain incomes to set off the amount of tax payable in China (with limits in time and amount). (Articles 23 and 24, Corporate Income Tax Act.)

Non-China Tax Resident Companies with Permanent Establishment (PE)

A company which is not tax resident in China is still subject to Chinese corporate income tax if it has an office or establishment in China.

The domestic concept of office or establishment refers to the places that the company conducts production activities and business operations within the territory of China, including:

- Places of management, business organisations, and offices.
- Factories, farms, and places where natural resources are extracted or exploited.
- Places where labour services are provided (for example, consulting services).
- Places where projects such as construction, installation, assembly, repair, and exploration are carried out.
- Other places or establishments where production activities and operations are carried out (for example, where a foreign phone production company hires a Chinese company to assemble the phones in China).

(Article 5, Implementation Regulation.)

A non-tax resident company with an office or establishment in China pays Chinese corporate income tax on:

- Income derived by that office or establishment from sources in China.
- Income derived from outside China that is effectively connected with that office or establishment.

For the taxation of a non-tax resident company that derives income from China with a PE in China, see *Non-Resident Companies with China-Sourced Income*.

Permanent Establishment

The definition of PE is set out in the DTAs entered into by China and specified by domestic interpretations. However, the domestic concept of office or establishment could be broader than that of PE.

As a general principle of Chinese law, the provisions set out under international treaties may prevail over domestic legislation. However, the Chinese definition of office or establishment applies where:

- No DTA is available.
- A DTA has been entered into but has not come into force at that time.

Permanent Establishment Under Double Tax Agreements

DTAs entered into by China are based on the OECD Model Tax Treaty or the UN Model Tax Treaty. The OECD commentary to article 5 of the OECD Model Tax Treaty as well as the UN commentary to article 5 of the UN Model Tax Treaty are generally considered an important aid to interpreting a DTA, in particular to establish whether a PE exists in China.

A company has a PE in a jurisdiction if either:

- It has a fixed place of business in that jurisdiction through which its business is wholly or partly carried on (see *Permanent Establishment as Fixed Place of Business*).
- A person acting for the company has and habitually exercises in that territory authority to conclude contracts in the company's name (the dependent agent). See *Dependent Agent as Permanent Establishment*.

(Article 5, OECD Model Tax Treaty.)

The term "permanent establishment" also encompasses:

- A building site, a construction, assembly, or installation project, or supervisory activities in connection with these, but only if that site, project, or activities last more than six months.
- The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for that purpose, but only if activities of that nature continue within a Contracting State for a period (or periods) aggregating more than 183 days in any 12-month period starting or ending in the fiscal year concerned.

(Article 5, UN Model Tax Treaty.)

The definition of PE in DTAs entered into by China is mainly a combination of the two model tax treaties, while the definition of PE may vary in different DTAs.

Permanent Establishment as Fixed Place of Business

Under the OECD Model Tax Treaty, a fixed place of business through which the business of a foreign company is wholly or partially carried out can be any of the following:

- A place of management.
- A branch.
- An office.
- A factory.
- A workshop.
- A mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.
- A building site or construction or installation project that lasts more than 12 months.

(Articles 5.2 and 5.3, OECD Model Tax Treaty.)

Under the commentary to the OECD Model Tax Treaty, "fixed" means that there must be both:

- A link between the place of business and a specific geographical point.
- A certain degree of permanency.

This requirement excludes any temporary place of business.

Activities that are purely preparatory or ancillary to the main business carried out by a non-resident company are not considered to be carried out at a PE even where they are carried out through a fixed place of business (article 5.4, OECD Model Tax Treaty). This includes:

- Storing, displaying, or delivering the company's goods or merchandise.
- Maintaining the company's goods or merchandise for the purpose of:
    - storage, display, or delivery; or
    - processing by another person.
- Buying goods or merchandise for the company.
- Collecting information for the company.

(Article 5(4), OECD Model Tax Treaty.)

Additionally, OECD has published its guidance on tax treaties to solve the concern related to creating PEs during the COVID-19 pandemic. According to OECD, the exceptional and temporary change of the location where employees exercise their employment because of the pandemic should not create new PEs for the employer. This includes working from home and the temporary conclusion of contracts in employees' or agents' homes.

Dependent Agent as Permanent Establishment

A dependent agent is a person acting for the company which habitually exercises in that territory authority to conclude contracts in the company's name.

The commentary to the OECD Model Tax Treaty states that this includes contracts that:

- Bind the company even if they are not literally in the company's name.
- Relate to the company's business proper (as opposed, for example, to contracts concerning only the company's internal operations).

However, an agent's activities do not give rise to a PE if the agent is independent and is acting in the ordinary course of their business (article 5(6), OECD Model Tax Treaty).

Allocating Profits to a Permanent Establishment in China

Generally, China refers to the authorised OECD approach for the attribution of profits to a PE, as described in *OECD: 2010 Report on the Attribution of Profits to Permanent Establishments dated (22 July 2010)* (PE Report).

The authorised OECD approach sets out a functionally separate entity approach: profits are attributed to a PE as if it were an independent enterprise.

Domestic law does not offer much guidance on the attribution of profits to a PE. A non-resident company with a place or establishment in China is required to keep complete accounting books to accurately record and calculate its taxable income. If it fails to do so, or the records clearly do not match the functions performed and the risks borne by the PE, Chinese tax authority could levy tax on the PE using a deemed profit method. In practice, the deemed profit rate could range from 15% to 50% or higher, depending on specific situation of the PE and Chinese tax authority's final assessment. (Article 5, Notice of State Administration of Taxation on Promulgation of the Administrative Measures on Assessment and Collection of Income Tax from Non-resident Enterprises, *Notice on Assessment and Collection of Income Tax from Non-resident Enterprises*.)

Taxation of Non-Resident Companies with Permanent Establishment in China

According to DTAs entered into by China, non-resident companies that obtain income through a PE in China must pay taxes in China on the worldwide income attributable to the Chinese PE.

The taxable base of a Chinese PE for non-resident income tax purposes is determined pursuant to the provisions on corporate income tax, for example, subject to the following:

- The transfer-pricing regulations, including articles in the Corporate Income Tax Act and the Implementation Regulation, as well as the *Announcement on Issuing the Measures for the Administration of Adjustments under Special Tax Investigation and Mutual Consultation Procedures*.

- Other applicable regulations, including Notice on Assessment and Collection of Income Tax from Non-resident Enterprises.

The statutory tax rate applicable to Chinese PEs is 25%.

Non-Resident Companies with China-Sourced Income

China-sourced income is generally taxable there unless a DTA or a domestic exclusion or exemption prevents that taxation.

China-sourced income for non-residents could be classified into two main categories:

- Income derived from China obtained by non-residents without an office or PE in China.
- Income derived from China obtained by non-residents with at least one office or PE in China, but the income is not effectively connected with the office or PE.

Subject to the existence of a DTA or domestic provision preventing double taxation, under Chinese law some types of China-sourced income are subject to taxation in China when obtained by non-residents. Some of the most significant items of China-sourced income for non-resident companies include:

- Gains from equity investments deriving from an investee in relation to equity investment such as dividends and bonuses.
- Interest income deriving from providing funds to others which do not constitute equity investment or through funds of the enterprise used by others, including:
    - interest on deposits;
    - loan interest;
    - bond interest; and
    - arrears interest.
- Rental income deriving from providing the right of use of:
    - fixed assets;
    - packaging materials; or
    - any other tangible assets.
- Income from royalties deriving from providing the right of use of:
    - patent rights;
    - non-patented technologies;
    - trademark rights;
    - copyright; and

    - any other concession rights.

- Income from transfer of property deriving from transfer of:
    - fixed assets;
    - biological assets;
    - intangible assets;
    - equity; and
    - creditor's rights.

Taxes to non-resident companies are normally levied as a withholding tax at a rate of 10%.

Where withholding tax is imposed, the payor is held as the withholding agent and must file a withholding agent tax return.

Residence: Flowchart

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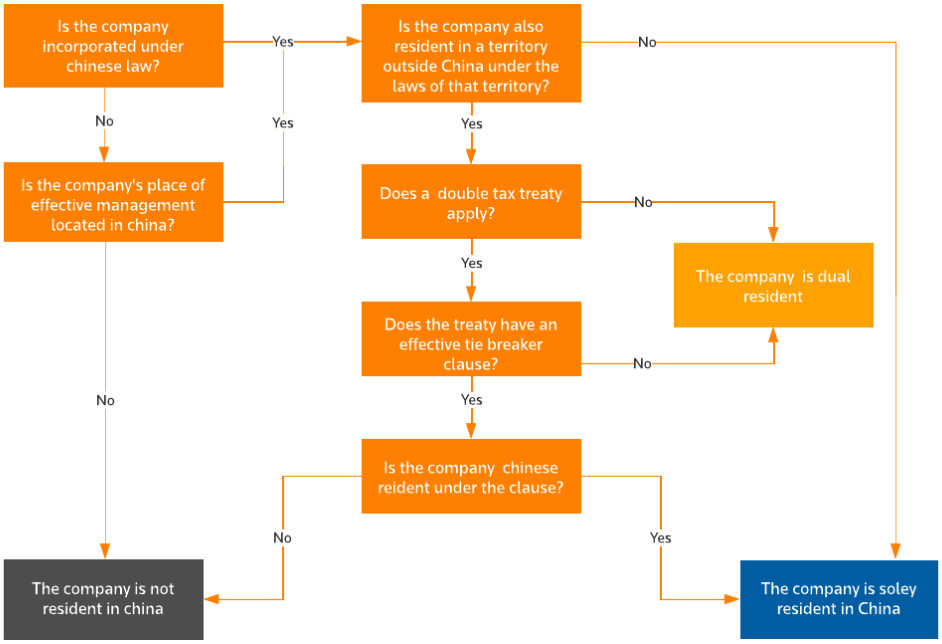
Residence: Flowchart



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