

## **An Insight into the Combined Enterprise Income Tax Filing by Enterprises with Trans-regional Branches**

Prior to the unification of PRC enterprise income tax (“EIT”) systems for domestic enterprises and FIEs, different rules were applied to combined EIT filing by domestic enterprises and FIEs having trans-regional branches. The EIT laws and regulations governing domestic enterprises (the “Old EIT Regime”) use "independent economic accounting" criteria to define a taxpayer. A branch would be recognized as an unit of “independent economic accounting”, if it: 1) has a settlement bank account; 2) has established independent books and prepares its own financial reports; 3) independently calculate profits and loss. In practice, the satisfaction of aforesaid requirements is subject to the discretion of local tax bureaus. Under the EIT Laws and regulations governing FIEs and foreign companies (the “Old FEIT Regime”), headquarter shall file and pay EIT on a consolidation basis for the all the incomes (including manufacturing incomes, operation incomes, other incomes, etc.) derived by all its branches from both inside and outside of Mainland China. The Old FEIT Regime also provided practical details on the combined EIT filing, e.g. requirements for combined EIT filing, process on combined EIT filing, determination of applicable tax rates of different branches, offset of profit & loss among branches and losses carry forward by branches etc.

The new EIT laws and regulations (the “New EIT Regime”) unified the systems of EIT combined filing by headquarters and branches. Under the New EIT Regime, it is clarified that the headquarter shall compute the overall taxable income by combining the profit & loss of the headquarter and all the branches; the headquarter and the branches shall make provisional EIT filings at their respective locations on a monthly or quarterly basis; after the end of the fiscal year, the headquarter shall conduct final settlement of the annual EIT. Due to the fact that many branches of domestic enterprises have been making EIT provisional filing locally before the implementation of the New EIT Regime, the impacts of applying the new combined EIT filing system to the domestic enterprises are relatively small. However, for FIEs, the new combined EIT filing system might probably increase the overall tax costs and compliance costs of the headquarters and their branches:

- Under the Old FEIT Regime, as EIT of branches should be combined by headquarter, the in-charge tax bureaus of the branches would only require the headquarter to provide Confirmation Letter on Combined EIT Filing and Payment and would less likely to carry out close scrutiny upon the branches.

However, under the New EIT Regime, the local tax bureaus of the branches would strengthen their supervisions upon the branches. For example, the branches shall not only submit tax filing materials, but also present financial materials to its local tax bureaus; the branches shall obtain the Confirmation on Items under Verification and Record from the tax bureaus; and each tax bureau in-charge of each branch shall have the right to check the EIT apportioned to the branch at its locality as well as the indicators for the calculation of such apportionment. Therefore, the compliance costs for FIEs would significantly increase, and the financial reports of headquarter shall be disclosed to all the local tax bureaus.

- The local supports and subsidies provided by local governments are calculated based on the tax revenue derived by local governments. The provisional filing of EIT by branches at their locations would unavoidably decrease the EIT to be paid by headquarter to its in-charge tax bureau, and therefore might weaken the bargain power of headquarter. In this respect, the overall supports and subsidies entitled to both headquarter and branches might be changed.
- Under the old FEIT Regime, for the branches engaged in manufacturing, trading and services, the headquarter shall compute the branches' EIT at the rates that are applicable to the enterprises which are engaged in the same kind of business at branches' locations; in practice, the headquarter usually simply calculate the overall EIT (including those of the branches) base on its applicable tax rate and makes payment at the headquarter's location. Under the New EIT Regime, the branches shall compute their payable EITs based on their applicable local tax rates and pay EITs locally.

Under the New EIT Regime, branches do not have to file and prepay EIT at their locations if such branches do not have the functions of independent production and operation, do not pay business tax or value added tax locally, and are engaged in internal auxiliary activities. In practice, we noticed that a large number of branches of FIEs are engaged in non-operational business while their business scopes are operational in nature. Now many local tax bureaus including those in Beijing, Shanghai and Guangzhou have already requested the operational branches of FIEs established within their respective jurisdictions to prepay the EIT locally, in our experience, the tax bureaus would define the "operational branches" based on the business scopes stated on the branches' business licenses.

In light of this, changing the business scopes of the branches from operational nature to non-operational nature has become the first option to avoid prepaying EIT locally. However, changing of business scopes shall be subject to the approval of the local Administration of Industry and Commerce. As an alternative to the aforesaid option, increasing the prepaid amount by the headquarter may retain EIT as much as possible to the location of the headquarter, e.g. 1) to set up an independent manufacturing or operational division in the headquarter, which division is able to book its revenue, salary and assets separately, such division can be treated as an additional branch and file its apportioned provisional EIT at the headquarter's location; and 2) to properly (and to the extent permitted by law) adjust the amounts of operational revenues, salaries, assets, etc. among various branches (including the division within the headquarter which could be treated as a branch for EIT purposes), with which method to adjust the taxable income apportionments to these branches. Anyway, these options are subject to the tolerance of the in-charge tax bureaus of the branches.

It is expected that the Ministry and Finance and State Administration of Taxation may continuously promulgate rules and measures during the implementation of the new combined EIT filing system for enterprises with trans-regional branches, taxpayers should stay tone with further guidelines and clarifications announced by the authorities.

[This article was published by LexisNexis on China Legal Review in October 2008 (issue [19])

If you have any questions on the above or need further help, please contact:

Clare Lu (Senior Partner) email: yi.lu@rwlawyers.com

Catherine Chen (Senior Partner) email: catherine.chen@rwlawyers.com