



New Tax Filing System for Headquarters and Branches Across Provinces under Corporate Income Tax Regime

New Corporate Income Tax Filing System

The Ministry of Finance ("MoF"), the State Administration of Taxation ("SAT") and the People's Bank of China issued the following circulars regarding the new tax filing system under the Corporate Income Tax ("CIT") regime:

- Circular Guo Shui Han [2008] No.44 ("Circular 44") dated 9 January 2008 which attaches the CIT returns to be used for monthly (quarterly) provisional tax filings;
- Circular Cai Yu [2008] No.10 ("Circular 10") dated 15 January 2008 which provides the policy on how the CIT liabilities shall be calculated and settled by the headquarters and branches across different provinces in China, and how the CIT revenue shall be allocated between central and local governments for taxpayers with headquarters and branches.

The new filing system has attracted much attention from foreign invested enterprises with headquarters and branches across different provinces. We summarize the salient points that are of their most interest as follows:

Calculation of CIT Payable

In both provisional and annual CIT filings, the profit and loss of the headquarters and all the branches should first be combined in order to come up with the overall taxable income and CIT payable for the company. This is in line with the principle of "combined tax filing" under the new CIT regime.

"Allocation Process" during Provisional Tax Filings

The "allocation process" will take place at provisional filings stage in the following fashion:

Step 1: During each provisional filing, the overall CIT payable will be first allocated between the headquarters and the "participating branches" (see below) on 50:50 basis.

Party to pay the tax	Headquarters	Participating Branch
Allocation percentage of overall tax payable	50%	50%

Step 2: And then the allocated amount for the "participating branches" (50%) will further be allocated according to the three parameters, namely, gross revenue, salary cost and asset value of the respective branches. The calculation is illustrated as follows:

CIT to be pre-paid by a branch at the local level	=	50% of the CIT revenue of the enterprise	X	Allocation ratio for the branch
Whereas:				
Allocation ratio for the branch	=	$\frac{\text{Total revenue of the branch}}{\text{Total revenue of ALL branches}}$	X 0.35 +	$\frac{\text{Total salary cost of the branch}}{\text{Total salary cost of ALL branches}}$
			X 0.35 +	$\frac{\text{Total asset of the branch}}{\text{Total asset of ALL branches}}$
				X 0.30

The allocated amounts will be paid to the respective tax bureaus at the localities of the headquarters and each branch accordingly.

"Distribution Process" during Provisional Tax Filings

It is also important for the taxpayers to note the distribution of the tax payable between the central government and local governments of the headquarters and the "participating branches".

The table below illustrates the "distribution" process of the tax payable allocated.

Party to pay the tax		Headquarters	Headquarters	Participating Branches
Allocation percentage of overall tax payable		25% (A)	25%(B)	50%(C)
Distribution between central and local governments	Revenue to the central government	(A) x 60%	(B) x 60%	(C) x 60%
	Revenue to the local government	(A) x 40%	-	(C) x 40%
	Payment to the temporary account which will be re-allocated among local governments	-	(B) x 40%	-

There will be internal procedure and basis to re-allocate the payment to the temporary account (i.e. B x 40%) regularly among local governments.

Annual Tax Filing and Settlement Process

An annual (reconciliation) CIT filing is only required to be performed by the headquarters to settle any overdue tax or tax refund for the whole company. The overall CIT payable does not need to be allocated to the branch level during the annual filing.

The "distribution" process would look like as follows:

Party to settle the tax		Headquarters		Participating Branches
Allocation percentage of overall net tax payable (refund)		100% (D)	-	-
Distribution between central and local governments	Revenue to the central government	(D) x 60%	-	-
	Revenue to the local government	-		
	Payment to the temporary account which will be re-allocated among local governments	(D) x 40%	-	-

Scope of Circular 10 Policy

For the purpose of Circular 10, the "participating branch" refers to the 1st-tier branch with principle operational functions. The 2nd and lower-tier branches should be consolidated into the 1st-tier branch for tax calculation and settlement. For clarity sake, the branch in the same location as the headquarters is grouped under "participating branch" for the distribution process. However, Circular 10 is not applicable to the following enterprises (and branches):

- A number of specified state-owned enterprises/groups, such as various state-owned banks, postal enterprises, oil-related enterprises, etc. because their tax revenues entirely belong to the central government;
- 1st-tier branches which undertake no principle operational functions and do not file business tax or VAT at their localities;
- "Small and Thin-profit Enterprises" qualified in the preceding year;
- Enterprises without any branch in other provinces, autonomous regions or municipal cities; and
- Overseas branches of tax resident enterprises.

Provisional Tax Returns

Circular 44, which was issued earlier than Circular 10, attaches the CIT returns to be used for monthly (quarterly) provisional tax filings. The returns have already set forth the items for the relevant information to be provided by the taxpayers which have the headquarters and branches across different provinces in accordance with the requirements as per Circular 10. However, the measures to determine the frequency of provisional filings, i.e. quarterly or monthly have not been promulgated yet.

Other Provisional CIT Filing Requirements under Circular 17

The SAT also issued a circular Guo Shui Fa [2008] No.17 ("Circular 17") on 30 January 2008 to clarify the following CIT compliance requirements on a temporary basis:

- For previous High/New Tech Enterprises ("Old HNTE") (i.e. the HNTEs that were qualified under the Foreign Enterprise Income Tax ("FEIT") regime), they should temporarily apply the CIT rate of 25% during provisional CIT filings in 2008 until they are re-assessed to qualify as HNTEs based on the new criteria under the CIT regime;
- Quarterly provisional CIT filing should be adopted for the 1st quarter of 2008 for the following types of enterprises (if they used to file monthly provisional tax returns under the old income tax regimes):
 - Enterprises outside the Shenzhen and Xiamen Special Economic Zones;
 - Non-manufacturing enterprises and domestic enterprises in the Shanghai Pudong New Area; and
 - Domestic enterprises which were approved to file combined tax returns under the old income tax regimes.

Apparently, there are still some further tax rules and administrative procedures to be put in place before the regular provisional tax filings can be adopted efficiently. So the SAT has to issue Circular 17 to buy some more time.

PwC Observations

After the announcement of the CIT Law in March 2007, many local governments, especially those in the inland provinces, have expressed strong concerns about the potential reduction in their CIT revenue collection in light of the principle of "combined filing at the headquarters" provided in the CIT law because most of the headquarters are located at the more developed cities in the coastal areas.

Apparently, the new tax filing system under Circular 10 and Circular 44 was developed primarily to address this kind of concerns. Now, the system clarifies the principle of "combined filing at the headquarters" provided in the CIT law to be referred to the calculation of the overall CIT payable at headquarters, instead of taking up all the CIT revenue (local portion) by the local governments at headquarters.

On the other hand, it aims to resolve the timing issue for tax revenue allocation, so that the local governments in the branches' locations may collect 50% of overall CIT payable during provisional tax filings, rather than awaiting until the CIT revenue is re-allocated from the central government.

The impact of this new filing system to FIEs and domestic enterprises may be different:

- Under the FEIT regime, FIEs with headquarters and branches were only required to file combined FEIT returns and settle tax payments at the headquarters level quarterly and annually, and no tax filing or settlement were required at the branch level. Although the new system will not affect the overall CIT liability of an FIE, it will obviously increase compliance burdens to most FIEs having numerous branches across different provinces. Their compliance burdens would be even heavier if their CIT filing is required to change from quarterly to monthly basis.
- Another concern to be faced by many FIEs is that they may have to adjust their government relationship strategies amongst the tax bureaus at the headquarters and branch levels. In most cases in the past, only the headquarters had to build up and maintain good working relationship with the tax bureau at its location because it paid all the FEIT to that bureau. Going forward, in light of this new system, the contribution of tax revenues to that bureau may diminish, and the headquarters have to manage the expectation of that bureau. Meanwhile, the branches will also need to build up good working relationships with their respective tax bureaus because they will all need to undergo tax registrations with and be subject to the supervision of their tax bureaus.
- In some localities, it is not uncommon to see their local governments grant certain financial subsidies or other benefits to the headquarters of FIEs out of its local finance, with reference to the magnitude of tax contributions by the FIEs. Since all the tax liability were combined and filed by the headquarters, the financial subsidies could be considerable. After the new system is introduced, the financial subsidies and other benefits from the local government to the headquarters may reduce. This will have financial impact to the FIE as a whole. It is not clear if the tax bureaus at the branches' locations would offer any financial subsidies and other benefits to the branches and at the same magnitude. Nevertheless, such financial subsidies and other benefits did not receive blessing from the MoF and SAT in the past.
- On the contrary, the new filing system may not widely impact most of the domestic enterprises because some of them used to file and pay income tax for their branches locally under the old Enterprise Income Tax ("EIT") regime where the results of their branches were separately accounted for.

Meanwhile, a few uncertainties regarding the new tax filing system still remain to be clarified.

1. First, theoretically, the profit and loss of headquarters and different branches should be allowed to offset each other under the "combined filing system" provided in the CIT law. However, Circular 10 requires that where headquarters and branches are subject to different tax rates, the taxable income and tax payable should be separately accounted for, based on their respective tax rates. In that case, further clarification is necessary for:
 - whether the prescribed "allocation process" between the headquarters and the "participating branches", and then among different branches should still be followed;
 - whether the profit and loss of the headquarters and branches can still be combined and set off each other to arrive at the overall net tax payable; and
 - whether such separate accounting for tax payable is required only for annual CIT filing or both during provisional and annual CIT filings.
2. Another concern is that since the tax payable by branches during provisional tax filings should be determined based on the three parameters of gross revenue, salary cost and asset values, whether the enterprises will be required to prepare for separate audited financial statements for each branch. If so, then this would further increase the administrative time and costs of taxpayers.

3. Circular 10 addresses that if there are any surcharges and penalty charged to the company, such payments will be levied at the location where they are charged. Then the same will be shared between the central government and local governments on the normal ratio of 60:40. They do not follow the "allocation process" between the headquarters and branches. Nevertheless, it is not explicit on how to deal with overdue tax chargeable as a result of tax audits or transfer pricing investigations.

This new tax filing system will be effective from 1 January 2008. Since it is a brand-new system, it is not unreasonable to expect unclear administration procedures, different interpretation problems or unique situations coming up in the process of implementation. Taxpayers should stay tune with any further guidelines and clarifications provided by the MoF and SAT, as well as the local-level tax bureaus.

We will follow up on all these uncertainty and report in our future issues of News Flash.

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