Comparing Representative Office and Wholly Foreign Owned Enterprise

Key Points Foreign Investors need to know
ABOUT US

Ecovis is a leading global consulting firm with its origins in Continental Europe. It has over 4,000 people operating in over 50 countries. Its consulting focus and core competencies lie in the areas of company registration, tax consultation, payroll, accounting, auditing and legal advice.

The particular strength of Ecovis is the combination of personal advice at a local level with the general expertise of an international and interdisciplinary network of professionals.

Every office can rely on Ecovis’ qualified local specialists as well as our worldwide network of experts. This diversified expertise provides clients with effective support, especially in the field of international transactions and investments - from preparation in the client’s home country to support in the target market.

In its consulting work Ecovis concentrates mainly on mid-sized firms. Both nationally and internationally, its one-stop-shop concept ensures all-round support in legal, fiscal, managerial and administrative issues. The name Ecovis, a combination of the terms economy and vision, expresses both its international character and its focus on the future and growth.

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A Representative Office ("RO") has been a commonly used investment vehicle for foreign investors to test the Chinese market because of several advantages. However, a RO can only be permitted to engage in liaison and auxiliary activities and is forbidden to conduct any business activities. In practice, a RO goes beyond the above mentioned permitted liaison or auxiliary activities, therefore, the Chinese government imposed more and more restrict control in terms of legal and tax issues on ROs since 2010.

1. New changes on set up and operation of a RO:
   - The head office has to be existent for at least two years;
   - Legalized incorporation documents and bank reference letter have to be provided for setting up a RO;
   - The legalized incorporation documents of the head office shall be provided when renewing the RO registration certificate;
   - RO has to take part in the annual inspection and has to provide finance information audited by a local CPA firm;
   - Public announcement should be made on the designated newspaper in term of RO establishment or change;
   - RO can only hire four representatives including chief representative ("CR"), previously there had been no restrictions on the amount of representatives, as such RO can bring as many foreigners into China as they like;

2. A RO is now required to take the annual inspection from March 1 to June 30 each year with the registration authority; For passing the annual inspection, the following documents should be submitted:
   - Annual report (a standard form from the registration authority to be filled in online);
   - Financial information audited by a local CPA firm;
   - Tax Audit Report issued by a local CTA firm; and
   - De-registration of representatives exceeding the allowed four.
   - If a RO fails to do the annual inspection between March 1 to June 30 each year or provides false information in its annual report, the RO will be required to make corrections and/or be imposed a penalty (RMB 30,000) be revoked its registration certificate; so that their head office is not allowed to establish any RO in China within 5 years after the revoking date of the registration certificate.

3. Tax burden of a RO is increased greatly
   The tax burden for RO’s can be calculated according to three different methods, depending on the accounting standards of the office. Taking the cost-plus method as an example it can be seen that the tax payements have increased. If a RO is treaty resident eligible for treaty treatment but failed to apply for approval and therefore paid excessive taxes, the RO is allowed to re-open application for treaty treatment within 3 years as of the date when the tax was paid to obtain a refund.

Based on the above, we can clearly see that the Chinese government puts a more strict supervision on a ROs set up as well as its on-going operation.

Due to the above-mentioned new rules, more and more ROs have already been changed to WFOE.

To be or not to be an RO?

Due to changing tax burden RO start to transform into WFOE’s.

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**FDI IN PR CHINA**

"Foreign Investors should carefully think if it is meaningful to set up a RO in China and consider rather setting up a WFOE.”

Lily Gao, Senior Legal Manager at Ecovis Beijing, China
Today, a Wholly Foreign-Owned Enterprise (WFOE) is the most common legal structure to enter the Chinese market. Due to the latest changes more and more businesses either consider setting a WFOE or change their existing structure to WFOE.

A WFOE is a limited liability company, which does not require any Chinese partner. The ownership therefore remains fully to the foreign investors. It is also allowed to issue local RMB invoices (“fapiao”) with a Fapiao. You can run a “real” business.

Besides those advantages, further ones are:
- HR advantages: ability to hire employees directly
- No restriction on the number of foreign staff members
- No minimum years of establishment for the headquarter
- Limited liability
- Direct billing
- Directly engage in business

However, a certain amount of registered capital is required to set up a WFOE in mainland China. For a limited liability company with one single shareholder the required amount of registered capital accumulates to RMB 100,000. However, the exact amount required depends on the number of owners, the business scope, the location and the cash flow of the company. It is recommended to contribute a higher amount of registered capital than required since this increases the credibility of the enterprise and refunding is very difficult. In addition, it is not “lost” money. The registered capital can be used immediately to pay salary, rent and other costs. Therefore, it is should be deemed as a pre-payment.

Another important term is the “Total Investment”.

Although the initial set up cost seems to be higher for a WFOE than for a RO, in the long run the WFOE is particularly favourable due to their different tax burden. Assuming a WFOE is run like a RO in China. That means, you don’t have any local business and every month your WFOE issues invoices to its headquarter for funding your operation in China. Any payment received is from your headquarter.

Based on this scenario, the tax burden for a WFOE would be considerably less expensive since the total tax burden would be only 6.72% VAT. Therefore a WFOE would be the better option. This is also depicted in the graph.

Taking as an example a company that has RMB 500,000 total operating expenses, the total tax burden for WFOE and RO differ widely. The RO tax is RMB 58,450 whereas the WFOE tax is RMB 33,600.

From this point of view, a WFOE is preferable and less expensive in the long run. In the mentioned example the WFOE pays every month RMB 24,850 less than the RO.

That is RMB 298,200 yearly.

Those facts have convinced a lot of companies to change into WFOE; making WFOE more popular than ever among the possible legal structures for foreign direct investments.

However, we would like to remind you that there are other factors to consider when deciding about the structure of your entity, like the legal, tax compliance and on-going cost issues. It is recommended to look for professional advise before starting with any restructuring.
Qualification

According to the relative laws and regulations in China, a RO has no qualification of a separate legal entity, which means, the RO is not an independent entity according to the Chinese laws and regulations, and cannot do any business in China. It is only as a contact place for the business of their investor company. Instead, after registration, the WFOE will get the qualification of legal person, which can do business and provide local formal “fapiao” which is preferred by local customers.

Calculation of Taxation

According to the Chinese laws and regulations, the calculation of taxation of a RO shall be based on the costs and expenses incurred, that means, the more costs and expenses for a RO, the more taxation shall be paid. Instead, the calculation of taxation of a WFOE shall be based on the revenue and profit they get in China, moreover, the expenses and cost of the WFOE could be deducted from the revenue which can further reduce the profit tax burden of the WFOE.

Human Resource Management

As mentioned above, a RO has no qualification of legal person, so it cannot employ local staff by itself directly, but only through a designated Human Resource Management Company in China, such as FESCO or CIIC etc. The RO shall pay the service fees to the Human Resource Management Company, which will incur more additional cost for the RO. In addition, the employees may not be so loyal to the RO since they are the formal employees of the HR agent not the RO, moreover, not easy for ROs to manage the employees well. While the WFOE can hire local employees directly, and take care of all payroll matters by itself which will save money and reduce profit tax burden since all payroll expense can be deducted from the revenue of the WFOE. In addition, the WFOE will have full management power on all its employees.

Protection for the Parent Company

Since the WFOE in China is a limited liability company and therefore a separate legal entity, it can be protective for the parent company in Europe. In case of severe problems, such as legal conflicts or accidents resulting in punishments imposed by the People’s Court and/or huge amounts of compensation payable, the WFOE will be sued and has to pay the burden. This will not affect the parent company in Europe. However, this is different for ROs. Since the RO is not a separate legal entity, any problems arising in China might negatively affect the parent company in Europe.

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Advantages when operating a WFOE

“Not only does a WFOE bring tax advantages but also operationally more freedom”

Richard Hoffmann, Partner, Ecovis Beijing, China

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Richard Hoffmann
Partner
“It is said that “guanxi”, meaning connections, is important in China. We have been in China for a long time and we have good contacts to many authorities in different areas. This helps us with a very important aspect: most recent updates. We use this inside knowledge to inform our client base and friends about upcoming changes for anyone running a business in China. Knowledge is power – especially in China.

A few days ago one of our employees met high officials from the tax authorities in Beijing and became aware of inside information about how Representative Offices (ROs) will be treated in future. The tax officials declared that they will increase pressure on ROs – forcing them to pay their taxes from 2011 onwards.

Since most ROs have very high expenditures, the total taxes that have to be paid may accumulate to an immense amount. In addition to this, tax authorities often charge high fines for entities not paying in time. Thus, delayed tax payments for 2011 and 2012 can become very expensive. Moreover, the RO faces the risk to have its registration certificate revoked. In this situation the parent company will not be allowed to operate or establish any RO in China for the following five years anymore.

Since 2011 regulations for ROs have changed. Previously many ROs have been exempted from tax payments. However, now they have the obligation to pay taxes. But most ROs are not in compliance with these regulations and continue as before. They do not pay taxes or far too less. That is why authorities will start chasing ROs to make sure that all outstanding and future tax liabilities are cleared.

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Insights on Treatment of ROs

Pressure increases

ROs are subject to Corporate Income Tax and Business Tax. Their total tax burden is either calculated using the deemed profit or actual income method and is generally about 11.69% in Beijing.

We want to draw your attention to the changed situation and want to inform you that from now on tax authorities will have an unwavering eye on ROs. All offices, which have not paid taxes in the two previous years, are strongly recommended to do so as soon as possible. It is important to build up a strategy, have someone who can assist you to clear tax obligations and lobby with tax authorities.

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<tr>
<th>Calculation Methods</th>
<th>Applicability</th>
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<tbody>
<tr>
<td>Actual Amount Method (Primary)</td>
<td>Can maintain accounting books and official and valid vouchers</td>
</tr>
<tr>
<td></td>
<td>Can accurately calculate its actual turnover and profits which correspond ends with the actual functions performed and risks borne by RO</td>
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<tr>
<td>Deemed Amount Methods (Secondary)</td>
<td>Cost-Plus</td>
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<tr>
<td></td>
<td>Can provide accurate details of its operation expenses</td>
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<tr>
<td></td>
<td>Cannot substantiate its income or cost</td>
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<tr>
<td>Deemed Profit based on gross revenue</td>
<td>Can provide accurate revenue</td>
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<td>Cannot clearly record the costs and expenses</td>
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