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Establishing RO or WFOE

To set up a Representative Office (hereinafter referred to as "RO") in China used to be a common way for foreign investors that intend to enter into China. The main reason is that RO is easy to establish. However, China has imposed more registration restrictions and tougher tax rules on Representative Offices since 2010. The establishment and maintenance of representative offices have been restricted and discouraged. And it is becoming much more expensive from a tax point of view. On the other hand, the establishment of Wholly Foreign Owned Enterprise (hereinafter referred to as "WFOE") has become much more convenient and straightforward. Foreign investors may consider setting up a service type WFOE rather than an RO now.

The main reasons are as follows:

1. Scope of Business

The biggest disadvantage of RO is that it is not allowed to engage in any profit-making activities except for those activities China has agreed with in international agreements or treaties. RO may only act as a liaison and promotion office for its head office. Where an RO engages in any profit-making business operation in any way, the registration authority shall order it to make corrections, confiscate illegal income, confiscate tools, equipment, raw materials, products (commodities) and other properties used exclusively for profit-making activities, and impose a fine of RMB50,000 to RMB500,000. If the circumstances are serious, the registration certificate shall be revoked.

WFOE can be entitled to perform many more business activities like consultancy, trading, etc. The business scope of a WFOE can even be expanded or changed. If a service type WFOE wishes to expand into trading business, it can expand its business scope accordingly.

2. Employment

RO is not allowed to employ Chinese personnel directly. It shall engage a local dispatching service agency designated by the Chinese Government to employ Chinese personnel. Typically, RO will sign a labor dispatching service contract with the agency. Under such service contract the agency agrees to provide, and the RO agrees to pay for employee hiring services. After the establishment of the employment relationship, the agency will handle, on a monthly basis, the employee's mandatory contributions to the social insurance and housing fund plan. Besides, in addition to the chief representative, the head office can only appoint 1 to 3 representatives according to business needs.

In contrast, WFOE can employ Chinese and foreign personnel, make salary payment and handle social insurance and housing fund contributions for the employees directly and independently. And there is no quota on the hiring of foreigners.

3. Tax Burden

Even though RO is not permitted to earn income in China, it is nevertheless subject to taxation. Most ROs are taxed based on their expenses by converting the expenses into deemed taxable incomes with the deemed profit margin stipulated by the tax authority. The tax authority has increased the deemed profit margin of RO from 10% to 15% in 2010, which has effectively raised the tax burden. Now the average tax burden of RO is approximately 8.36% of its total expenses.

A WFOE is taxed differently. It pays value added tax based on its business revenue. It can deduct expenses from revenues generated from business activities and pay corporate income tax on net profit. The tax burden of a service type WFOE is much lower than that of an RO.

As RO registered in Beijing is not required to pay VAT and its surcharges, the average tax burden of a Beijing RO could be lowered to around 4.41% of its total expenses. In case foreign investors prefer to enter into China market by establishing an RO, it is advisable to consider setting up the RO in Beijing unless there are other factors to be considered.

4. Registered capital

The main advantage of RO is that the head office is not required to contribute registered capital when it applies for the establishment of an RO. It can remit funds regularly based on the need to cover salaries and other daily expenses of the RO in China.

However, under the new Company Law of the PRC, the minimum registered capital requirement for company establishment has been abolished and the paid-up capital registration system has been replaced with a subscribed capital registration system. Now the company investor(s)/shareholder(s) may decide on the capital amount, method and deadline for capital contributions at their own discretion.

5. Conversion from RO to WFOE

A WFOE is an independent legal entity under Chinese law, whereas the RO is not. There is no direct conversion from RO to WFOE. Conversion from RO to WFOE actually involves setting up a WFOE first and then deregister the RO.

The above are important considerations that should certainly be taken into account for foreign investors wishing to enter into China and also for existing ROs.

If you wish to obtain more information or assistance, please visit the official website of Kaizen CPA Limited at www.kaizencpa.com or contact us through the following and talk to our professionals:
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