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TAX

PRC Non-Resident Enterprise Tax Series

Managing Chinese taxable presence exposures from secondment arrangements

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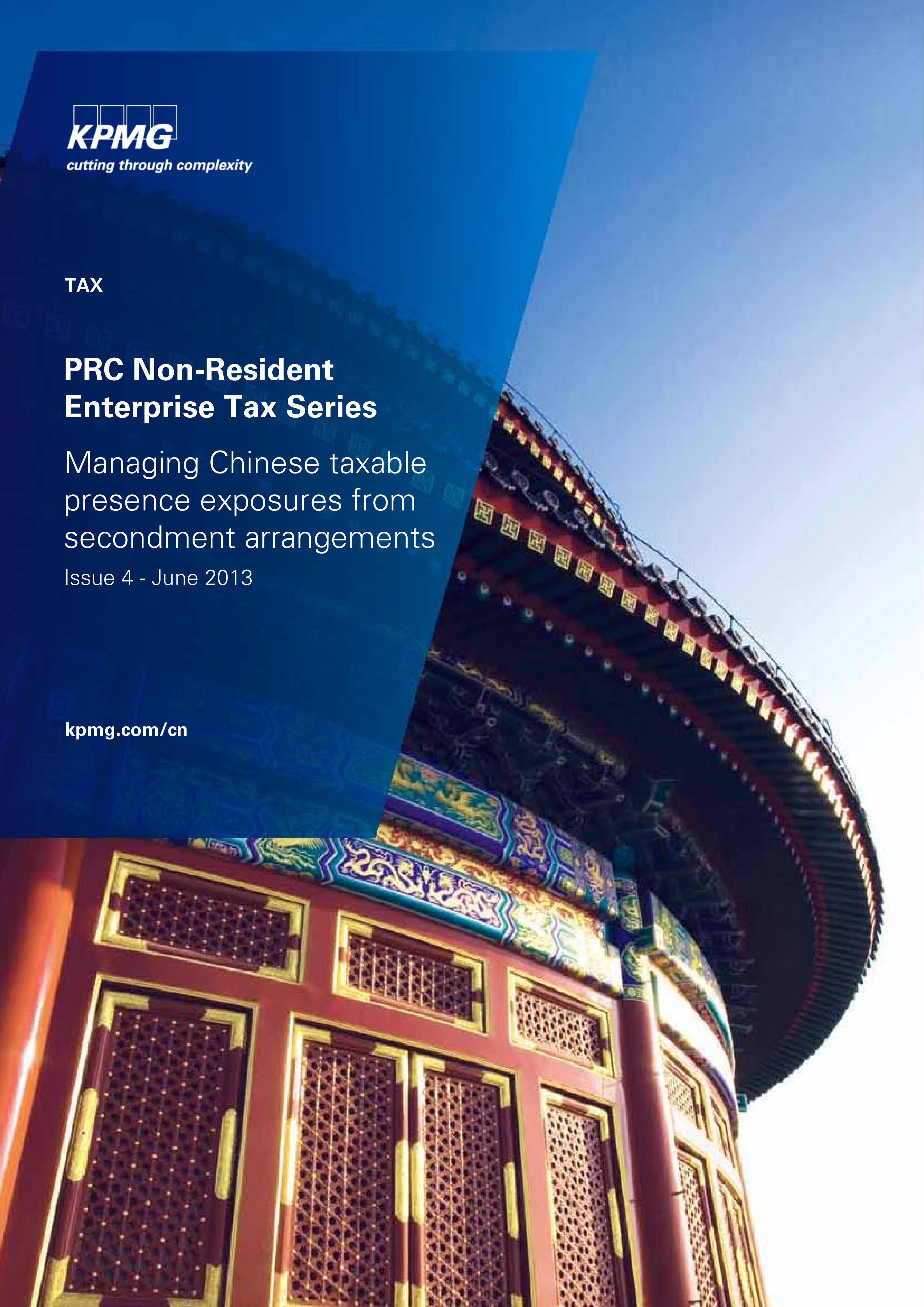

Introduction

This publication follows on from two previous articles in this series, 'Beneficial Ownership and Indirect Disposals' published in March 2010, and 'Indirect offshore, direct offshore and onshore disposals in an M&A context' issued in April 2012. These two prior articles focused on the increased rigour of the Chinese tax regime for taxing non-residents on passive types of income, which has been a major area of concern in recent years for foreign businesses investing and operating in China (PRC). This development has occurred through the Chinese tax authorities limiting the use of treaty withholding tax reductions on investment income[1], and via the putting in place of a system for identifying and taxing gains on indirect disposals of Chinese equity interests[2].

In parallel, changes have been taking place with the separate Chinese tax regime for taxing non-residents with a taxable presence in China on an assessment basis. In particular, practice has been evolving in identifying when the dispatch of staff to China on secondments by a non-resident enterprise gives rise to a taxable presence in China for that non-resident enterprise. If a foreign enterprise is deemed to have a taxable presence in China, the foreign enterprise will likely incur Chinese corporate income tax (CIT) and turnover tax costs, and will be required to fulfil a series of Chinese tax registration and filing obligations.

The latest clarifications in the new Announcement 19 (2013) on the circumstances in which secondments give rise to Chinese taxable presence for foreign enterprises are the principal focus of this article. We set out the historical background which preceded and prompted the issuance of these clarifications, and point to the quirks of the new provisions, which may require detailed consideration by foreign enterprises when refining their secondment arrangements. We also look more broadly at Announcement 19 (the Announcement) as a step in the development and tougher enforcement of the rules on taxable presence in China, and give our thoughts on the shape of things to come.

The need for Announcement 19

Secondments made by multinational enterprises (MNEs), with investments and operations in China, to their Chinese affiliates have long been common[3]. While working under the direction of a Chinese company's (host entity) management and on the host entity's premises in China, the secondees typically retain their employment contract relationship with a foreign enterprise (home entity) overseas, and often continue to receive compensation from the home entity directly. The home entity in turn is reimbursed by the Chinese host entity for compensation costs incurred in relation to the Chinese assignment. Maintaining the employment relationship between the secondees and the foreign enterprise is important for the former to preserve their seniority or pension rights, and makes practical sense in any case where the secondees' stay in China is only intended to be temporary.

A consequence of dispatching staff to work in China under secondment arrangements is the potential to give rise to a taxable presence for the home entity in China, either as an establishment or place of business

[1] Circular 601 (2009), and subsequent clarifications in Announcement 30 (2012) and Circular 165 (2013).
[2] Circular 698 (2009), directed against tax-motivated disposals of offshore holding companies of PRC enterprises.
[3] While data on the precise number of secondees in China is not available, a sense of the order of magnitude can be obtained by reference to the official statistics released by the Ministry of Human Resources and Social Security on the number of foreigners with Chinese work permits. Apparently, from 2003 to 2011, this figure more than doubled and now exceeds 340,000.

in China under the Chinese domestic tax law[4] or as a Chinese permanent establishment (PE), where a Chinese double tax agreement (DTA) is in place with the jurisdiction of the home entity.[5] This is due to the fact that, depending on how the secondment is structured and operated, an inference may be drawn that a secondee is actually acting on behalf of the home entity in rendering services to the host entity. This provision of services by a foreign company through personnel on the ground in China is one of the enumerated forms of taxable presence under both the domestic law and DTAs.

Until 2009, Chinese tax authorities generally accepted that secondment arrangements, such as those described above, should not give rise to a taxable presence in China for the home entity. Then, to the surprise of many foreign businesses, the Chinese State Administration of Taxation (SAT) issued Circular 103 (2009) in July 2009, instructing local tax authorities to scrutinise the secondment arrangements of non-resident enterprises in certain sectors to identify disguised service arrangements and impose tax accordingly. Some local tax authorities took a very aggressive approach in the enforcement of Circular 103.

A Chinese taxable presence may create significant tax costs for a foreign enterprise. Where a taxable presence of a foreign enterprise in China is identified, its active business income, such as trading income or service income, that is connected with or attributable to the taxable presence, will be subject to Chinese CIT at 25 percent. Furthermore, Chinese turnover taxes may apply to revenues that are deemed to be generated by the Chinese taxable presence. Finally, the foreign enterprise would need to fulfil a series of Chinese tax registration and filing obligations, which put it under the direct scrutiny of the PRC tax authorities.

The key to prevent a secondment arrangement from creating Chinese taxable presence for a foreign enterprise is to avoid it being characterised as a provision of services by the foreign enterprise in China. While no guidance had been issued by the Chinese tax authorities on how to distinguish secondment from service arrangements for CIT purposes, a 1997 individual income tax (IIT) circular, Notice 124 (1997), had clarified when an individual dispatched by a foreign company to render services to a Chinese company would be regarded as a de facto employee of the Chinese company, in the context of the "dependent personal services" article of a Chinese DTA. In particular these criteria looked at:

- Whether the Chinese company assumes the responsibility and risk of the individual's work
- Whether the Chinese company is entitled to provide working instructions to the individual
- Whether the Chinese company controls and has responsibility for the work location of the individual
- Whether the amount paid by the Chinese company to the dispatching foreign enterprise is directly based on the remuneration of the individual
- Whether the Chinese company provides tools and raw materials needed by the individual in rendering the services
- Whether the Chinese company is entitled to decide the number and qualifications of such individuals.

Notice 124 is modelled after Article 15 of the Commentary to the OECD treaty convention (Article 15 of OECD Commentary). It targets tax abuses where foreign individuals are dispatched into China by a foreign Human Resource (HR) company on short-term basis (e.g., no more than 183 days within any 12-month

[4] The domestic law definition covers a very broadly defined range of activities and does not contain limitations with respect to the scale of operations or length of time they continue.
[5] This is a more restrictive definition, applied where a DTA is in force, requiring the taxable presence to meet certain threshold criteria and fall within the descriptions of enumerated forms, such as a fixed place of business, a dependant agency, or extended provision of services in country.

period) to serve a Chinese resident enterprise and do not pay Chinese IIT based on the argument that they are not employed by the Chinese resident enterprise. Despite the underlying connectivity, Notice 124 does not directly address the issue of whether foreign individuals dispatched into China on longer-term basis (e.g., more than 183 days within any 12-month period) by a foreign home entity that is not in the HR business are de facto employees of that foreign enterprise and thereby creates a Chinese taxable presence from a Chinese CIT standpoint.

In 2010, the SAT issued Circular 75 to serve as a comprehensive interpretation of the China-Singapore DTA as well as other Chinese DTAs with similar provisions. Circular 75 provided some clarification on how to distinguish secondment from service arrangements for CIT purposes. However, it was only relevant in situations where a DTA is in place between China and the home entity's jurisdiction of tax residence, and the host entity is a subsidiary of the home entity, not the wider scenario where the home entity does not directly or indirectly own the host entity. Notably, the criteria included in Circular 75 echoed those in Notice 124, such as the question of who supervises the secondees, who bears the risk and responsibility for their work, who chooses the secondees, and who decides how many secondees are needed. However, Circular 75 incorporated additional criteria, including that, to avoid the foreign parent company having a taxable presence in China, it must not make a profit from the secondment arrangement and it must not bear the salaries of the seconded personnel. In other words, the foreign parent must be fully reimbursed for the secondees' compensation costs, but receive no more than this, from the Chinese host entity.

As mentioned above, Circular 103 called for more rigorous scrutiny of secondment arrangements. However, no general guidance has been prescribed for foreign enterprises that wish to take measures to limit their taxable presence exposures. Nearly four years after the issuance of Circular 103, Announcement 19 is released to provide guidance for those situations not covered by Circular 75. Most of the criteria set out are similar to those included in the Notice 124 of 1997 and hence Article 15 of the OECD Commentary. However, Announcement 19 contains a number of quirks, which depart from the conventional approaches, and need to be considered carefully by MNEs when structuring secondment arrangements.

What does Announcement 19 say?

Announcement 19's clarifications set out fundamental and reference factors to the identification of a taxable presence in China. The fundamental factor in determining the economic employer of the secondees will be on who bears the responsibilities and risks in relation to the work products of the secondees and who normally reviews and appraises the job performance of the secondees. Beyond this fundamental factor, the circular also sets out certain secondary reference factors. In general, satisfaction of the fundamental factor and at least one reference factor would be conclusive evidence that the foreign enterprise has a taxable presence in China. The reference factors are summarised in the following.

Firstly, significance is attached to the label used for any salary reimbursements paid by the host entity to a foreign enterprise. Labelling payments as management fees or as some kind of service fee and booking accounting entries would undermine the taxpayer position that the secondment arrangement is not service provision by the home entity.

Secondly, negative implications will be drawn from a decision by the foreign enterprise to hold on to, and not pay on to the secondees some part of the reimbursement received from the Chinese host entity. This would result in the foreign enterprise making a profit from the arrangement, and according to Announcement 19, is viewed negatively by the Chinese tax authorities in the determination of taxable presence.

Thirdly, the Chinese tax authorities appear to be unconcerned if the foreign enterprise pays more to the secondees for their China duties than received as reimbursement from the Chinese host entity, i.e., under-reimbursement. In this situation, the Chinese circular emphasises that as long as the secondees settle Chinese IIT on the "full amounts" of compensation paid to them by the seconding foreign enterprise, under-reimbursement does not suggest the existence of a taxable presence for the dispatching foreign enterprise.

Lastly, if the foreign enterprise decides the number, the qualification, the remuneration and the working locations of the secondees in China, that is viewed as negative evidence supporting the service characterisation, and hence a taxable presence for the foreign enterprise. This factor is tied to the fundamental factor described earlier, i.e., the foreign enterprise's continuing control over the secondees suggests that it is the real employer of the secondees.

A helpful feature of Announcement 19 is the 'stewardship exception'. According to this provision, if a foreign enterprise dispatches secondees into China to safeguard its interests as a shareholder of the Chinese host entity by rendering investment advice or participating in the shareholder meetings or the board meetings of the host entity, the activities of the secondees in China will not trigger a taxable presence for the foreign enterprise. This position is generally consistent with the international common practice, by recognising the fact that stewardship activities do not directly lead to business profits generation and should be treated more leniently compared with regular business activities.

A prescribed list of documents that tax authorities should review in reaching their determination is also set out in Announcement 19, providing guidance to taxpayers on what documents should be maintained in support of their tax positions where they have secondment arrangements in place. The process of obtaining tax clearance with a view to facilitating foreign exchange settlement and remittance of the reimbursements has also been clarified, with the interpretative guidelines accompanying the Announcement specifically noting that the tax authorities are not to postpone or hinder the issuance of tax clearance certificates if all requisite information has been provided.

How to interpret Announcement 19?

First and foremost, the Announcement is welcome simply because the greater clarity in the determination criteria for a taxable presence should allow for the assessment of a taxable presence in China on a more consistent basis, with greater efficiency and fewer controversies. Foreign enterprises will now need to set about reviewing their existing secondment arrangements and modify these where they offend against the clarified rules. They will need to put systems in place to collect and retain sufficiently comprehensive documentation to support their tax position. This is particularly the case given that, with the release of the Announcement, tax authorities will be expected to enforce these clarified rules more vigorously going forward.

Announcement 19 does not cover the situation of dual lines of job reporting. Secondees in China frequently have dual lines of reporting for legitimate business reasons and both overseas business line leaders and the local management of the Chinese host entity will provide input on the parameters of the job assignment and the review of the secondees' job performance. The SAT informally clarified that such a dual line of reporting and joint management are not necessarily fatal in the assessment of Chinese taxable presence for the foreign enterprise, but should be disclosed to the local tax authorities in charge of the Chinese host entity. Still, caution should be exercised in situations where secondees in China solely report to an overseas entity, even though the underlying circumstances are beyond the control of the host entity. For instance, the general manager of a wholly foreign owned enterprise (WFOE) may be seconded from its foreign parent. If the WFOE does not maintain a board of directors in China, the general manager, being the top-ranked officer of the Chinese company, will have to report to the foreign parent out of business and legal necessity. The SAT has not indicated whether situations like this would create a taxable presence for the foreign parent in China. Businesses in China are encouraged to consult their local tax authorities in charge to seek clarifications.

The absence of a requirement to fully reimburse the home entity for the costs of the secondee may be of assistance in some instances. Where staff are seconded by a foreign company to a JV they operate with Chinese partners, it is sometimes preferable not to fully charge the salaries of the foreign staff to the JV given the disparity in Chinese and foreign salaries. While this would have previously been considered to result in a potential taxable presence risk, this would no longer be an issue under Announcement 19.

From the perspective of international tax common practice, it is unusual to link the payment of IIT on the secondees' full amount of compensation borne by the foreign enterprise with the determination of whether the foreign enterprise has a taxable presence in China from a CIT perspective. It appears that the SAT believes that the CIT position of a MNE and the IIT position of the MNE's secondees in China should be consistent; if the MNE argues that for CIT purposes that the secondees are employees of the Chinese host entity in economic substance, the secondees should pay their Chinese IIT accordingly.

The concept of 'full amount' is not defined in Announcement. Where a secondee under dual employment contracts is paid by the home entity, during his secondment period in China, for job duties performed inside China (for the host entity) and outside China (for another group entity), based on informal clarifications from the SAT, the 'full amount' of compensation should refer to the portion corresponding to job duties performed inside China for the host entity only.

The acceptance of under-reimbursement and the consideration of IIT compliance are departures from the international norm. Many other countries might view under-reimbursement as evidence that the secondees at least partially work for the foreign enterprise, thereby creating a taxable presence of the foreign enterprise in China, because the foreign enterprise bears at least some of the cost of the secondees during the assignment. Presumably, under-reimbursement to the foreign enterprise means less tax deduction for the Chinese entity. If Chinese IIT is settled on the full amount of the secondees' compensation during their assignment in China, the SAT apparently believes that the Chinese CIT and IIT bases are not eroded.

As regards to the proviso that the foreign enterprise may not hold on to any part of the reimbursement received from the Chinese host entity, this factor may be viewed as overly restrictive. Other jurisdictions would be more relaxed about a foreign enterprise making a small mark-up on the secondment of employees to cover the administrative costs of making the arrangement. After all, whether a foreign enterprise derives a profit from the secondment arrangement depend less on how much reimbursement it receives from China than who is the real employer of the secondees and the beneficiary of their activities in China. If a foreign enterprise economically employs the secondees and directly benefits from their business activities in China directly, under-reimbursement does not preclude the results that the foreign enterprise derives profit from the personnel assignment.

In summary, it appears that while looking to learn from best practice elsewhere, the SAT is willing, where they consider it appropriate, to depart from international tax norms. As such, while European tax authorities may wring their hands and European tax policy makers complain that compliance with international tax rules makes it difficult for them to tackle perceived tax abuse, the Chinese authorities, when focused on a matter, are more likely to take more drastic actions. This is clear by the way in which innovative Chinese rules on indirect offshore equity disposals and on access to tax treaty benefits were formulated, which differ from the globally accepted approach (as described in the first two articles in this series), and is also demonstrated in Announcement 19.

How can KPMG China assist?

The challenges to secondment arrangements, which began with Circular 103, targeted what was essentially 'low hanging fruit' regarding taxing foreign enterprise taxable presence in China. As the foreign exchange settlement system requires foreign enterprises to approach the tax authorities for tax clearance prior to making remittances to home enterprises, secondment arrangements were more readily brought to the attention of the tax authorities. Announcement 19 may herald a decisive shift by the PRC tax authorities towards more rigorous enforcement of taxable presence, and may well prompt wholesale reorganisation of the conduct of business operations by MNEs in China.

In light of these developments in enforcement approach, the time is right to take concrete action to tighten up or restructure management processes and contractual and financial arrangements covering secondments to limit tax risks. In these regard, KPMG can offer assistance in the following areas:

- Firstly, KPMG can review existing secondment arrangements in order to help assess the potential PRC tax risks, and advise on new cross-border arrangements or modifications to existing arrangements to mitigate the exposure of a taxable presence in China.

- Secondly, KPMG can advise on the procedures for obtaining tax clearance certificates and assist in preparing and filing the applications for the home entity.

- Thirdly, KPMG can represent the home entity or the host entity in discussions with the Chinese tax authorities with a view to obtaining agreement that the secondment arrangements do not give rise to a taxable presence in China.

- Fourthly, where a taxable presence is determined to exist, KPMG can advise on the tax registration and filing requirements, as well as representing the home entity in discussions with the Chinese tax authorities to seek a more limited tax exposure, through agreement on applied deemed profit margins and onshore-offshore income apportionments.

- Finally, KPMG can help the host entity navigate through the Chinese foreign exchange regulations and successfully remit secondment-related reimbursement payments to the home entity.

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