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# CHINA TAX ALERT

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## Clarifications issued on when secondment creates Chinese taxable presence for foreign enterprises

**Regulations discussed in this issue:**

- Announcement on Issues Concerning Levying Corporate Income Tax on Services Provided by Non-residents through Seconding Personnel to China, SAT Announcement [2013] No. 19 (Announcement 19)
- Interpretations on Clauses of the Agreement between the Government of the People's Republic of China and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and of the Protocol thereto, Guo Shui Fa [2010] No. 75 (Circular 75)

On 19 April 2013, the State Administration of Taxation (SAT) issued Announcement 19 to provide guidance on when cross-border secondment of expatriates by foreign enterprises into China may create a PRC taxable presence. Announcement 19 is a welcome development for multinational companies (MNCs) doing business in China. It reduces uncertainty as to when a foreign enterprise might create Chinese Corporate Income Tax (CIT) exposures through its secondment arrangements. It may also facilitate the process of obtaining tax clearance by a Chinese company when it seeks to make reimbursement remittances overseas pursuant to secondment arrangements.

### Background

Since the introduction of the CIT Law in 2008, the SAT has been progressively developing the rules for the taxation of non-residents. As part of this, a number of draft circulars were drawn up to set out the circumstances when an employee (Secondee), dispatched from a foreign enterprise (Home Entity) to an enterprise in China (Host Entity), would give rise to a taxable establishment or place of business in China under the Chinese domestic tax law or a Chinese permanent establishment (PE) under a Chinese double tax agreement (DTA). An affirmative determination would bring the Home Entity into the Chinese CIT net.

Under a typical cross-border secondment arrangement, even after the Secondees are sent to work in China at the site of the Host Entity, the Home Entity remains the legal employer of the Secondees and may continue to pay part or all of the remuneration to the Secondees. The Host Entity will make reimbursement payments to the Home Entity. The retention of the Secondees' employment relationship with the Home Entity may be important, amongst other matters, for the preservation of the Secondees' seniority or pension rights in the Home Entity, considering that the Secondees' stay in China is temporary and one day they will be repatriated to the Home Entity.

*"It is important for companies to maintain written secondment agreements that clearly indicate the true nature of the arrangements at hand. In practice, many companies fail to withstand the challenge of the tax authorities simply because they do not have sufficient documentation to substantiate their claims."*

*Abe Zhao*
*GICT National Leader*
*KPMG China*

If the Secondees are viewed as the employees of the Home Entity rather than the Host Entity when they work in China, such business activities of the Secondees may constitute a taxable establishment or place of business of the Home Entity in China, which will be subject to Chinese CIT on the connected income. Conversely, the Home Entity is not to be subject to CIT if the Secondees are viewed as employees of the Host Entity in China, although their legal employment relationships with the Home Entity remain in effect. In the past, the precise application of the CIT Law in this area has been uncertain due to the lack of regulatory guidance.

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, Article 5(7) of Circular 75 has provided some helpful direction vis-à-vis when deputation of expatriates into China by the Home Entity constitutes a Chinese PE. However, Circular 75 did not address the wider scenario where the Home Entity does not directly or indirectly own the Host Entity.

### Announcement 19

The regulatory gaps mentioned above are now filled by Announcement 19. According to the new circular, the "fundamental criterion" for the Home Entity to be regarded as providing services through its own staff in China, and thus having a taxable establishment or place of business in China, is whether the Home Entity bears all or part of the responsibilities and risks in relation to the work products of the Secondees, and whether it is the Home Entity that normally reviews and appraises the job performance of the Secondees. In the DTA context, if the establishment or place of business through which the services are provided is of a relatively fixed and permanent nature, it will be regarded as a PE for the Home Entity in China.

Beyond the "fundamental criterion," Announcement 19 also prescribes the following factors ("reference factors") in deciding whether the Secondees are in substance the employees of the Home Entity:

- The Host Entity in China pays the Home Entity management fees or makes payments in the nature of service fees;
- The payment to the Home Entity from the Host Entity exceeds the Secondees' wages, salaries, social security contributions, and other expenses borne by the Home Entity;
- The Home Entity does not pass on all the related payments made by the Host Entity to the Secondees; instead, the Home Entity retains a certain amount of such payments;
- PRC Individual Income Tax ("IIT") is not paid on the full amount of the Secondees' wages and salaries borne by the Home Entity; and
- The Home Entity decides the number, the qualification, the remuneration and the working locations of the Secondees in China.

If the "fundamental criterion" is met and at least one of the "reference factors" is satisfied, the Secondees will generally be considered employees of the Home Entity rendering services in China. If so, the Home Entity is normally treated as having a taxable establishment or place of business in China. In the DTA context, if the Secondees who are viewed as employees of the Home Entity render services in China for longer than six months, a service PE is normally created. In these cases, the Home Entity will be required to file CIT returns and pay the CIT based on the income derived from or attributable to the services so provided.

Announcement 19 requires that the tax authority in charge focus on reviewing the following documents or information in assessing whether the Home Entity has any CIT liability in respect of the secondment arrangement:

*"Many Host Entities have had their foreign exchange remittance applications held up because they have difficulty convincing the tax bureaux in charge of the true nature of the reimbursed employment costs to be remitted to the foreign Home Entities. Announcement 19 may potentially facilitate this process of obtaining tax clearance in secondment reimbursement situations"*

*William Zhang*
*Tax Partner, GICT*
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- The contract, agreement or covenant between / among the Home Entity, the Host Entity, and the Secondees;
- The management guidelines that the Home Entity or the Host Entity has set for the Secondees, including specific rules such as the Secondees' work duties, work contents, performance reviews, and undertaking of risks;
- Information on the payments made by the Host Entity to the Home Entity, the associated accounting treatment, and the filing and settlement of the Chinese IIT for the Secondees; and
- Information indicating situations where the Host Entity makes hidden payments to the Home Entity in connection with the secondment - via setting off multiple transactions, forgiveness of debts, related party transactions, or other methods.

It is important to note that besides reviewing documents, the Chinese tax authorities will examine the economic substance surrounding the secondment arrangement and the manner in which the secondment arrangement is executed in reality to ascertain the nature of the secondment arrangement.

Finally, Announcement 19 contains a "stewardship exception" for the deputation of foreign employees by the Home Entity in China. Specifically, if the Home Entity dispatches its employees to the Host Entity only to exercise the former's shareholder rights and safeguard its shareholder interest in the Host Entity, the Home Entity would not have a taxable establishment or PE in China merely because its employees perform these stewardship functions at the Host Entity's place of business. Stewardship functions may include rendering investment advice to the Home Entity with respect to the Host Entity and participating in the shareholder meetings or the board meetings of the Host Entity.

### KPMG observations

In general, Announcement 19 delivers positive news for MNCs with secondment arrangements in China. First, by identifying the "fundamental criterion" and the "reference factors" to which the tax authorities should have regard, Announcement 19 clarifies the evaluation standard for local tax authorities nationwide. Assessment of taxable establishment or PE can now be carried out on a more consistent basis in China. Second, the "stewardship exception" offers relief to certain shareholder-related activities of foreign employees in China and can prove useful to taxpayers in certain situations. Finally, by prescribing the specific documentation that tax authorities should review, Announcement 19 provides guidance to taxpayers on what supporting documents should be maintained in support of their tax positions where they have secondment arrangements in place.

Nevertheless, Announcement 19 did not answer all questions in the secondment area and further clarifications from the SAT in the following fields would be useful.

1 In Announcement 19, the "fundamental criterion" for determining whether the Secondees are employees of the Home Entity is whether the Home Entity normally reviews and appraises the performance of the Secondees. In practice, for bona fide business reasons, some Secondees have dual lines of reporting when it comes to job duties, e.g., they report to both the CEO of the Host Entity and the business line leaders of the Home Entity. The local CEO and the overseas business line leaders jointly review the job performance of the Secondees. Announcement 19 does not specifically address such a scenario, and would seem to create a PE risk for the Home Entity if it has input into the performance review of the Secondees.

2 One of the "reference factors" in the Announcement is that if the Home Entity receives from the Host Entity more than what it pays to the Secondees, this increases the risk of taxable presence in China. However, it may be reasonable for the Host Entity to compensate the Home Entity for the indirect administrative costs of managing the secondment program, given the amount of coordination work typically required.

3 If the Secondees are directly compensated by the Home Entity and the Host Entity fails to reimburse or fully reimburse the Home Entity for the compensation costs, the accompanying interpretative guidance to Announcement 19 appears to imply that no Chinese taxable presence will be created, as long as IIT is paid on the full amount of the Secondees' wages and salaries borne by the Home Entity. This position would appear to be inconsistent with Circular 75, which clearly states that if the Home Entity (foreign parent) bears the compensation cost for the Secondees working in the Host Entity (Chinese subsidiary), it is a factor indicating that the Secondees are in fact working for the Home Entity.

4 It is not precisely clear why the payment of IIT on the Secondees' wages and salaries borne by the Home Entity is connected with the determination of whether the Home Entity has a taxable presence in China from a CIT perspective. It appears that the Announcement is making an inference that, if the Secondees do not settle Chinese IIT on income received from the Home Entity, such a position implies that the Secondees are not really the employees of the Host Entity. In practice, a Secondee sometimes signs dual employment contracts with the Host Entity and the Home Entity during the secondment period and performs job duties associated with the two contracts within (onshore duties) and outside China (offshore duties). In such a case, it is unclear whether the Secondee must pay Chinese IIT for the compensation received for the offshore duties in order for the Home Entity to avoid a taxable presence in China.

In summary, Announcement 19 represents a measure by the Chinese tax authorities to tighten up the tax enforcement against non-residents on their taxable presence in China (whether in the domestic law or the DTA context) and meanwhile increase tax certainty for taxpayers. MNCs with personnel stationed in China should conduct a thorough review of internal documentation related to their secondment arrangements, including contracts between the Home Entity, Host Entity and the Secondees, and internal management protocols for the use of the Secondees, to support an assertion of no taxable presence on audit. Based on the review, MNCs should take proactive measures to rectify any weaknesses identified and improve documentation to mitigate PRC tax risks.

*"Foreign companies should not underestimate the potential VAT exposure of remitting employment cost reimbursements under secondment arrangements. In general, tax clearance should be obtained from both the state tax bureau which is in charge of CIT and VAT and the local tax bureau which is in charge of IIT to carry out a remittance."*

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