

TAX ISSUES IN CHINA FOR SECONDMENT ARRANGEMENTS IN MULTINATIONAL CORPORATIONS

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ABSTRACT

Since the establishment of corporate income tax law in 2008, tax authorities in China have continued to perfect tax administration, in particular for non-resident enterprises, for which there are many uncertain areas of implementation. This paper provides a full coverage on the development and critics of expatriate secondment starting from Guoshuifa [2010] No.75 (“Circular 75”) to the recent Announcement 19. It analyzes the merits of and practical difficulties in the implementation of Announcement 19.

INTRODUCTION

Since the establishment of corporate income tax law in 2008, tax authorities in China have continued to perfect tax administration, in particular for non-resident enterprises, for which there are many uncertain areas of implementation. Non-resident enterprises in this paper refer to either

- enterprises established according to foreign or regional law that have a management organization that is not based within the territory of China and have no offices or business premises in China, but receive income sourced from Chinese territory, or
- enterprises that have established offices and business premises, but the relevant income has no actual connection to such offices and premises (China Briefing, 2013).

MNCs often transfer their expertise to Chinese affiliates by relocating their overseas employees to China. They often face specific taxation problem of non-resident enterprises at large. To design an employment structure that attains the best tax advantage, the dispatching company usually dispatches its employees (as secondees) to the enterprise (the Chinese company) through secondment so that corporate income tax is not imposed on non-resident enterprises. Usually a secondee retains his or her employment and position in the dispatching company but is temporarily stationed in the Chinese company for a pre-determined period. The question is whether this practice creates a taxable establishment or place of business (a “taxable presence”) in China under Chinese domestic tax law or a Chinese permanent establishment (“PE”) under the Chinese double-tax agreement. If the secondment arrangement constitutes a taxable presence or PE, then corporate income tax must be paid on the income generated by the secondee.

This paper provides a full coverage on the development and critics of expatriate secondment starting from Guoshuifa [2010] No.75 (“Circular 75”) to the recent Announcement 19. It analyzes the merits of and practical difficulties in the implementation of Announcement 19.

CIRCULAR 75

Circular 75, which was issued on 26 July 2010, interpreted the double taxation arrangement between China and Singapore and also provided a firmer meaning of taxable presence and PE and the circumstances that lead to these two situations. Article 5 of Circular 75 states that if an overseas parent company dispatches its personnel to work for a Chinese subsidiary and the subsidiary has the right to control the work of the individual and assumes the risks and responsibilities for that work, then the overseas parent company is not deemed to have a taxable presence or PE in China. In this respect, remuneration to the individual is deemed to be paid by the Chinese subsidiary, regardless of the channel of payment and whether one of the contracting parties is an overseas parent company. The pay is regarded as personal income that is subject to individual income tax (Hao et. al., 2010).

However, if a parent company assigns an individual to its Chinese subsidiary and any one of the following conditions is satisfied, then the individual is deemed to be working for the parent company in the country of the subsidiary (Hao et. al., 2010).

- The parent company directs the work of the individual and takes on the responsibilities and risks relating to that work.
- The parent company decides the number and qualifications of seconded individuals.
- The salary of the individual secondee is borne by the parent company.
- The parent company earns profits from the subsidiary as a result of the assignment of the secondee.

Although Circular 75 specifies that the parties must be comprised of an overseas parent company and its Chinese subsidiary, it implies that the parties can be any overseas company and a Chinese company. In addition, tax authorities take the “substance over form” principle in considering whether the parent company is the “real” employer of the individual.

Non-resident enterprises have been trying to circumvent these four conditions. Some non-resident enterprises remit the salaries of the dispatched individuals via the bank account of the overseas parent company, similar to the arrangement before secondment, but are subsequently reimbursed by the Chinese subsidiary under a service agreement. This is in substance a service fee for the salary expense reimbursement. Chinese tax authorities then tax the remittance to the overseas parent company as a service fee before the Chinese subsidiary issues a tax payment certificate to facilitate the remittance. It is unclear whether the tax authorities are notified of the reimbursement of salary expenses such that the overseas parent company is deemed to have borne the salary payment. (Hao et. al., 2010).

In other circumstances, certain extra charges in addition to the salary and pension of the seconded individual are imposed by the overseas parent company on the Chinese subsidiary for the secondment, such as airfare for the China-bound trip, accommodation for the first month of secondment, a secondment allowance, logistics arrangement fees, and others. The overseas parent company does not aim to make a profit but to recover the costs of the secondment arrangement. It is unclear whether Chinese tax authorities treat these fees as profit earned by the overseas parent company and therefore deem the company to have a PE in China (Hao et. al., 2010).

The lack of clarity about when a foreign enterprise might be regarded as having a taxable presence or PE in China and the subsequent exposure of secondment arrangements to Chinese corporate income tax was largely resolved by the release of Announcement 19.

ANNOUNCEMENT 19

On 19 April 2013, SAT released the Announcement of the State Administration of Taxation on Issues Concerning Enterprise Income Tax on Labor Services Provided in China by Personnel Dispatched by Non-resident Enterprises (“Announcement 19”) (SAT, 2013).

The spirit of Announcement 19 is to decide whether or not the dispatching company provides services through its own staff in China and, thus, has a taxable presence or PE in China. The “fundamental criterion” of Announcement 19 clearly states that if a company dispatching personnel to render services in China bears all or part of the responsibilities and risks in relation to the work of those personnel and normally reviews and evaluates their job performance, then that company shall be deemed to have a taxable presence in China. If the dispatching company is a tax treaty resident enterprise, then this establishment and place of business may create PE in China (KPMG, 2013).

Announcement 19 also explicitly mentions five “reference factors” used in deciding whether secondees are in fact employees of the dispatching company (KPMG, 2013).

- The Chinese company makes a payment to the dispatching company in the form of management or service fees.
- Payment from the Chinese company to the dispatching company exceeds the secondees’ salary, bonus, social security contributions, and other expenses as advanced by the dispatching company.
- Not all related expenses reimbursed by the Chinese company are paid to the secondees; instead, the dispatching company retains a portion of such payments as profit.
- Individual income tax is not paid in China on the full amount of the secondees’ salary that is paid by the home entity.
- The dispatching company is the decision-maker in terms of the number, qualifications, remuneration, and working locations of the secondees in China.

If the “fundamental criterion” is met and at least one of the “reference factors” is satisfied, then secondees will generally be considered employees of the dispatching company and the company will be treated as having a taxable presence or PE in China.

The exception to these reference factors in determining whether a dispatching company has a taxable presence or PE in China is when the dispatching company exercises its shareholders’ right and seeks to protect its interests in the Chinese company. Such action is regarded as a safe harbor provision. In this case, a secondee can perform services, for example, rendering investment advice to the dispatching company with respect to the Chinese company and participating in shareholder meetings or board meetings of the Chinese company (KPMG, 2013).

Documentation is crucial in forming a solid basis for the substance of a secondment. The necessary documents include the following (Ye et. al., 2013):

- an agreement between the non-resident enterprise, the Chinese company, and the secondee,
- internal management guidelines prepared by the non-resident enterprise or the Chinese company covering the secondee’s job responsibilities, risks, and evaluation,

- information on payments made by the Chinese company to the non-resident enterprise, the relevant accounting treatment, and the settlement of the secondee's individual income tax liability, and
- information on any disguised payments (e.g., offsetting, waiving of debt, related-party transactions) relating to the secondment.

Again, Chinese tax authorities examine the economic substance to determine how a secondment arrangement is actually executed. In addition to reviewing the documentation, it is equally important to examine the economic substance of the secondment arrangement. If the dispatching company has a taxable presence or PE in China, then both the dispatching company and the Chinese company (which shall withhold income tax for the dispatching company) must perform tax registration or file records in accordance with SAT's Decree No. 19 (2009). They must declare and pay corporate income tax on their income. If it is not feasible to accurately calculate the taxable income, then tax authorities are empowered to deem the taxable income in accordance with the relevant regulations (Dong et. al., 2013). Failure to follow this procedure will render the company subject to a deemed profit rate method by the tax authorities (Mullin, 2013).

MERITS OF ANNOUNCEMENT 19

Not only does Announcement 19 provide clearer guidelines on the secondment of expatriates to China by laying out the fundamental criterion and the reference factors used by tax authorities, it also facilitates the process of obtaining tax clearance by a Chinese company seeking to make reimbursement remittances overseas pursuant to secondment arrangements. Announcement 19 also states that if the dispatching company deploys individuals merely to exercise its shareholders' rights, then it is relieved from assessment. Moreover, the documentation specified by Chinese tax authorities clarifies their focus in assessing the parties involved in a secondment arrangement.

In particular, the first and second reference factors settle the uncertainties of Circular 75 on salary expense reimbursement. They state that any reimbursement in the form of a management fee or service fee with or without a mark-up constitutes PE in China. The reimbursement of any indirect administrative fee for coordinating a secondment beyond the amount paid to the secondee is regarded as meeting the second reference factor of a taxable presence or PE in China. To avoid any PE risk, the dispatching company must bear any handling costs above the salary and other expenses of the secondee and should not retain any profits arising from the secondment.

The fifth reference factor, where the Chinese company decides the number, qualifications, remuneration, and working locations of secondees in China, confirms one of the criteria stipulated in Circular 75 on the number and qualifications of assigned individuals. It lends importance to the issue of who exerts control over secondment exercises, as this can result in a taxable presence or PE in China.

DIFFICULTIES IN THE IMPLEMENTATION OF ANNOUNCEMENT 19

There are certain areas where the execution of Announcement 19 encounters practical difficulties. A secondment contract does not usually explicitly state whether the reimbursement from the Chinese company to the dispatching company is regarded as a management fee or service fee, but tax authorities may deem it to fall under the first reference factor. A simple reimbursement mechanism without a service agreement between the dispatching company and the Chinese company may help, but will not protect the interests of both parties. Rather, the parties involved must devise a feasible solution so that tax authorities will not deem the dispatching company to fall under the first reference factor.

The second and third reference factors that set out that reimbursement should not be in excess of the secondee's salary and other recruitment expenses and that no profits should be retained pose another difficulty. An entity operating compensation remittance and reimbursement, such as a cost center within a group or an outsourced company, often sets a charge. Structuring this charge as part of the secondee's packages requires skill to satisfy the requirements of Announcement 19.

It is sometimes hard to categorize whether a secondee is only discharging his or her duties in safeguarding shareholders' interests, as laid out in Announcement 19. Expatriates usually perform various tasks in China in addition to protecting and enforcing investors' rights. Unofficial documents, such as daily work schedules and other evidence of work performed by the secondee, may show this to be the case, but it is doubtful whether these documents would be sufficient for the tax authorities.

It is unclear why the full payment of individual income tax is not deemed a taxable presence or PE in China. It also remains uncertain whether the remuneration of a secondee borne by the dispatching company as referred to in the fourth factor is limited to remuneration payable for his or her work within China. Thus, employment that includes job responsibilities in several locations in the Asia-Pacific region, which is very common nowadays, is not covered. In addition, Announcement 19 does not indicate which party paying individual income tax makes a difference in the tax authorities' view. These areas of ambiguity create grounds for the tax authorities to exercise discretion in implementation.

Chinese tax authorities take a rigorous view of whether secondment arrangements fall within the ambit of Announcement 19. To minimize the risk of challenges, all documentation relating to a secondment should thus be explicitly drafted such that it includes clear terms in all contracts, secondment letters, and policy, and should demonstrate how the contents of the documents are adhered to in practice.

SUMMARY

Circular 75 and the subsequent Announcement 19 provide clear guidance on how tax authorities assess the tax position of MNCs in terms of whether they have a taxable presence or PE in China. In particular, the two releases set out the factors used to assess salary reimbursement arrangements and the exertion of control in deploying expatriates. Although there are some practical difficulties in the implementation of Circular 75 and Announcement 19, MNCs are advised to properly and comprehensively prepare the necessary documentation and other evidence to demonstrate the nature of the work and services provided by secondees. MNCs must take proactive measures to rectify any weaknesses identified and improve their documentation to avoid heightened tax risks in China.

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