

## **China Targeting Secondment Arrangements**

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In early July 2009, China's international Taxation Administration Division of the State Administration of Taxation (SAT) issued an internal tax circular, Ji Bian Han [2009] No.103, entitled Notice Concerning the Inspection of Enterprise Income Tax Collection on Foreign Entities's Provision of Services to Domestic Companies through Secondment Arrangement (Notice 103). Notice 103 requires local tax authorities to carry out a country-wide specific tax audits on cross border secondment arrangements.

### **Details of Notice 103**

The main targets of this audit are non-resident enterprises, which obtain income from China by entering into secondment agreements with resident enterprises, seconding senior management or technical personnel to work in resident enterprises, and charging resident enterprises for the secondment. The tax audit will focus on enterprises in manufacturing and service industries, while every enterprise in the auto industry would be audited.

The tax authorities will inspect the tax filing records and outbound payment records to ascertain whether the audited resident enterprises have entered into secondment arrangements and made outbound secondment-related payments, if yes, whether the arrangements have been registered, filed with the tax authorities and whether relevant taxes have been duly paid in accordance with Provisional Administrative Measures Governing Tax Collection on Contracted Projects and Provision of Services by Non-Resident Enterprises, Decree No. 19 issued by SAT on 20 January 2009 (Decree 19).

The tax authorities may interview with the resident enterprises and the secondees, requesting for the provision of copies of secondment agreements, and information of the secondees (such as name, passport number, immigration records, position, job description etc).

In case the audited enterprises are found to have failed to comply with the relevant tax payment obligations stipulated in Decree 19, the tax authority may collect the unpaid or underpaid taxes together with the corresponding late payment surcharges and penalties. In case the accurate accounting records, vouchers on the costs and expenditures of the project are not available, the tax authorities may levy Corporate Income Tax (CIT) based on deemed profit margin method.

### **Background**

Since China opened its door to foreign investment thirty years ago, expatriate secondment arrangements have been very common in multinational corporations (MNCs) that have operations in China. Under such arrangement, the foreign MNCs (Home Entity) second their employees to the Chinese affiliates (Host Entity) to provide a series of

services, such as management services and technical support services. A secondment agreement will be entered into between the Home Entity and the Host Entity. Those employees would be entirely or partially paid by the Home Entity, and the Host Entity would reimburse the Home Entity for the costs of salaries, allowances and other fringe benefits that the Home Entity agrees to pay on behalf of the Host Entity during the course of the secondment with no profit mark-up. Under such agreement, the secondees would be regarded as the employees of the Host Entity, thus subject to Individual Income Tax (IIT) in respect of their remunerations obtained during the period. Chinese tax authorities used to agree that under the secondment arrangement, the Home Entity is not providing services to the Host Entity by virtue of sending the secondees to work in China, therefore the Home Entity does not constitute a Permanent Establishment (PE) in China.

On the contrary, in the event that the secondees are regarded as representing the Home Entity to provide services in China to the Host Entity, then the Home Entity might be deemed as constituting a PE in China. Under such circumstances, the Home Entity should be subject to CIT, and Business Tax (BT) for provision of services to the Host Entity.

Notice 103 indicates that China tax authorities may suspect that some Home Entities are using secondment arrangements as disguised forms of provision of services to the Host Entities to avoid Chinese taxes.

### **LehmanBrown's Observations**

Neither Notice 103 nor other existing rules provide clear guidelines to distinguish a secondment arrangement from a service agreement. Therefore it is expected that the SAT will issue more specific guidelines in due course on how to distinguish a secondment arrangement from a service agreement at a later stage.

Based on our research, a secondment arrangement should be clearly distinguished from a service arrangement. Under a secondment arrangement, the secondees normally work under the control and supervision of the Host Entity, and the Host Entity should benefit from and bear the risks associated with the secondees' work. On the other hand, under a service arrangement, the secondees continue to work under the control and supervision of the Home Entity to fulfill a service contract entered between the Home Entity and the Host Entity.

In practice, China tax authorities may consider the following factors when determining whether an arrangement is a service agreement, and whether a PE has been created:

- Which entity receives the benefits arising from the secondee's work?
- Which entity has the right to control the secondee's work and give instructions on it?
- Which entity bears the risks, costs, and responsibilities of the secondee's work?
- Which entity determines the compensation of the secondee and reviews the secondee's performance?
- Whether the secondee's work constitutes an inseparable part of the Host Entity?
- Is the charge-back merely the actual secondee's cost or does it contain a profit

mark-up?

### **Conclusion**

In the event that a secondment arrangement is deemed as provision of services in China by the tax authorities, the Home entity will be exposed to Business Tax, and if the Home Entity constitutes a PE in China, it will also be subject to Corporate Income Tax. The employees working for the PE will be subject to Individual Income Tax from the first day of their China assignment. The total tax liabilities could be significant compared with those under secondment arrangement. MNCs are suggested to review their existing cross border secondment arrangements, prepare appropriate documentation to provide strong evidence to substantiate the genuine nature of the secondment arrangements, or restructure the secondment arrangements in order to minimize the potential tax risks. MNCs may consider engaging professionals for assistance in provision of advisories, documentation preparation or dispute resolution in the course of tax audits.