Update on China Secondment Arrangements

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Background

Expatriate secondment arrangements have been very common for companies that have operations in China. Under such arrangements, the foreign (Home Entity) seconds 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 an agreement, the secondees would be regarded as the employees of the Host Entity, thus subject to Individual Income Tax (IIT) with respect to 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 Corporate Income Tax (CIT), and Business Tax (BT) for provision of services to the Host Entity.

Notice 103 – July 2009

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 audit on cross border secondment arrangements.

The main targets of this audit were to be non-resident enterprises which obtained 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 audits focused on enterprises in manufacturing and service industries, while every enterprise in the auto industry was also to be audited.

The tax authorities would inspect the tax filing records and outbound payment records to ascertain whether the audited resident enterprises had entered into secondment arrangements and made outbound secondment-related payments and, if so, 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 could interview the resident enterprises and the secondees, requesting the provision of copies of secondment agreements, and information on the secondees (such as name, passport number, immigration records, position, job description etc.).

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

Notice 19 – April 2013

On 19 April 2013, the State Administration of Taxation issued Notice 19, clarifying and providing guidance on the circumstances when a secondment arrangement may create a Chinese taxable presence for foreign enterprises. The issue of Notice 19 largely reduces the uncertainty as to when a Home Entity may create corporate income tax exposures in China.

According to Notice 19, 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 creating a PE under a Chinese double tax agreement, are if the Home Entity assumes fully or partially responsibilities and risks in relation to the work conducted by the secondees, and if the Home Entity assesses and reviews the job performance of the secondees.

Apart from the fundamental criterion mentioned above, Notice 19 also set out the following five supplementary factors when considering whether the secondees are in substance the employees of the Home Entity:

1. Whether the Host Entity pays the Home Entity management fees or service fees or makes payment to the Home Entity for the secondees;
2. Whether the Host Entity's reimbursements of the Home Entity for the salaries, social security contributions and other expenses exceeds the total amount paid for the secondees;
3. Whether the Home Entity does not pay the full amount received from the Host Entity to the secondees and retains a certain amount;
4. Whether the China IIT is not paid on the full amount of the salaries and wages of the secondees that is borne by the Home Entity;
5. Whether the Home Entity decides on the number, qualification, the remuneration standard and the working locations of the secondees.

According to SAT's interpretation, 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. In other words, the Home Entity shall be normally treated as having a taxable establishment or PE in China. Under this circumstance, the Home Entity will be required to file CIT based on the income derived attributable to the services provided.

Conclusion

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?

In the event that a secondment arrangement is deemed as a provision of services in China by the tax authorities, the Home Entity will be exposed to BT or VAT under the VAT reform starting in China from 1 August 2013, and if the Home Entity constitutes a PE in China, it will also be subject to CIT on a deemed profit basis. The employees working for the PE will be subject to IIT from the first day of their China assignment. The total tax liabilities could be significant compared with those under the secondment arrangement. Companies are therefore 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.