HAN KUN LAW OFFICES

Legal Commentary

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Tax Law

New Tax Rules on International Secondment Arrangement Released

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On May 6, 2013, the State Administration of Taxation (the "**SAT**") issued *the Announcement on Issues Relating to the Collection of Enterprise Income Tax on Labour Services Provided by Personnel Dispatched by Non-resident Enterprises within the Territory of China* (SAT Announcement [2013] No. 19, **"Announcement 19"**), which clarifies the enterprise income tax treatment, tax filing procedures, principles for tax collection and administration as well as other tax-related matters for secondment arrangements. Announcement No. 19 will come into effect on June 1, 2013, and will apply to unsettled matters that have taken place prior to the effective date.

Background

It is quite common for non-resident enterprises (the "**Dispatching Entity**") to send personnel to take management, technical or other positions in Chinese enterprises (the "**Recipient Entity**"), especially foreign invested enterprises that are affiliated with the Dispatching Entity. The domestic Recipient Entity will pay the Dispatching Entity employment expenses of the seconded personnel, such as salaries/wages and bonuses. Since the implementation of the new Enterprise Income Tax Law on January 1 2008, the tax authorities have enhanced the tax collection and administration in respect of non-resident enterprises. However, due to the lack of clear and specific provisions as to whether such secondment arrangement constitutes, for the Dispatching Entity, offices or establishments under the Enterprise Income Tax Law, it has been difficult for tax authorities to determine the appropriate tax treatment. The uncertainty in tax treatment in turn makes it difficult for the domestic Recipient Entity to obtain the Tax Certificate for Outbound Remittance (the "**Tax Certificate**"). As a result, the Recipient Entity could not remit expenses, such as salaries and wages, of the seconded personnel to the Dispatching Entity, which also leads to a negative impact on the accounting and tax treatment of the Recipient Entity.

The Current Regulations

On July 26 2010, the SAT issued the *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* (Guoshuifa [2010] No.75, "**Circular 75**"). Although Circular 75 is an interpretation of the provisions of tax treaty on the basis of Tax Treaty between China and Singapore (hereinafter referred to as the "**Treaty**"), it applies to the interpretation and enforcement of all tax treaties between China and a foreign jurisdiction under which the relevant provisions are consistent with terms of the Treaty.

The secondment arrangement of multinational corporations was mentioned by Circular 75 in its interpretation of the permanent establishment clause. Circular 75 sets out the criteria to determine whether such secondment arrangement constitutes a permanent establishment for the non-resident dispatching enterprise. Pursuant to Circular 75, the determination of whether the seconded personnel work for the dispatching parent company or the recipient domestic company should be established based on their roles in respect of: the direction of the work of the seconded personnel; assumption of the responsibility and risk of the seconded personnel's work; determination of the standard and quantity of such personnel; sharing of the salary cost of such personnel as well as whether the parent company makes profit from dispatching personnel to the subsidiary to conduct business. If the seconded personnel are deemed to work for the parent company and the parent company has constituted a permanent establishment in China, the Chinese tax authorities have the power to impose an enterprise income tax on the fees that the parent company collected from its subsidiaries for the abovementioned secondment activities.

Circular 75 for the first time explicitly provides for the enterprise income tax treatment under the international secondment arrangement after the implementation of the new Enterprise Income Tax Law. However, as Circular 75 provides interpretations of tax treaties, it is silent on the tax treatment in situations where the non-resident enterprise does not constitute a permanent establishment, but has a place/establishment of business under the Enterprise Income Tax Law. Furthermore, Circular 75 does not state the tax filing and payment method of non-resident enterprises or the coordination of tax collection and issuance of tax certificates.

New Tax Rules for Secondment Arrangements

Announcement 19 further clarifies the tax treatment for the international secondment arrangements.

1. Situations where a Place/Establishment of Business or Permanent Establishment is Constituted

In accordance with Circular 19, if the following conditions are both satisfied, the Dispatching Entity should generally be deemed to have a place/establishment of business in China through which services are provided as a result of the provision of services by the seconded personnel in China:

- the Dispatching Entity assumes some or all responsibilities and risks of the outcome of the work conducted by the seconded personnel, and
- the Dispatching Entity assesses the work performance of the seconded personnel under normal circumstances.

If the Dispatching Entity is a tax resident in a jurisdiction that has concluded a double tax treaty with China, and its place/establishment of business through which services are provided is relatively fixed and permanent, such place/establishment of business shall be regarded as a permanent establishment of the Dispatching Entity in China.

However, the Dispatching Entity, as a shareholder of the Recipient Entity, may dispatch its personnel to provide services in China for the sole purpose of exercising its shareholder's rights and/or protecting its legitimate rights and interests as shareholder. For instance, the seconded personnel may provide investment advice to the Recipient Entity, or attend the shareholders' meetings or board meetings on behalf of the Dispatching Entity. In such situations, the Dispatching Entity shall not be deemed as having a place/establishment of business or a permanent establishment in China, even though such activities take place in the business premise of the Recipient Entity.

2. Factors to be Considered and Documents to be Reviewed

The following factors shall be taken into account when making the judgement of whether the Dispatching Entity has a place/establishment of business or a permanent establishment in China. Please note that in principle, if the secondment arrangement falls within the situation as described above where a place/establishment of business or permanent establishment should be deemed to exist, and any of the following conditions are met, it can be concluded that a place of business/establishment or permanent establishment has been constituted.

- The Recipient Entity makes payments in the nature of management fees or service fees to the Dispatching Entity;
- The payment made by the Recipient Entity to the Dispatching Entity exceeds the salaries and wages, social security premiums and other costs actually paid by the Dispatching Entity;
- The Dispatching Entity retained a portion of the payment received from the Recipient Entity instead of disbursing it in full to the seconded personnel;
- Individual income tax is not paid on the entire amount of salaries and wages borne by the Dispatching Entity; and

- The number of dispatched personnel as well as their qualifications, remuneration criteria and place of work in China are determined by the Dispatching Entity.

The tax authorities will focus on reviewing the following documents in relation to the secondment arrangement for tax administration purposes:

- Contracts or agreements between the Dispatching Entity, the Recipient Entity and the seconded personnel;
- Management rules or regulations of the Dispatching Entity or the Recipient Entity for the seconded personnel, including provisions on their responsibilities, job descriptions, performance appraisal and risk-sharing;
- Payments made by the Recipient Entity to the Dispatching Entity and relevant accounting treatments, as well as individual income tax filing and payment documents for the seconded personnel; and
- Whether there is any hidden payment arrangement in relation to secondment activity, such as offsetting transactions, waiver of claims and related-party transactions.

The tax authorities will determine the enterprise income tax liability of the non-resident Dispatching Entity based on the above documents as well as the economic essence and the implementation status of the secondment arrangement.

3. Tax Payment and Calculation for Non-resident Dispatching Entities

The Dispatching Entity that is deemed to have a place/establishment of business or permanent establishment in China should perform tax registration with the in-charge tax authorities at the place of the projects (which is usually the locality of the Recipient Entity) within 30 days after the project contracts or agreements are signed pursuant to the *Interim Administrative Measures for the Taxation of Contracting Construction Projects and Providing Services of Non-Resident Enterprises* (Order of the State Administration of Taxation No.19).

In principle, the Dispatching Entity should itself make tax filings and declarations. The Dispatching Entity should calculate its income and declare and pay enterprise income taxes on an accurate and truthful basis. If the Dispatching Entity is unable to make tax filings and payments on an actual basis, tax authorities are entitled to assess and collect enterprise income taxes on a deemed-profit basis in accordance with the *Administrative Measures for the Assessment and Collection of Income Tax against Non-resident Enterprises* (Guoshuifa [2010] No. 19, **"Deemed-profit Measures"**). Pursuant to the Deemed-profit Measures, where a non-resident enterprise is taxed on the deemed-profit basis, the taxable income will be converted based on a pre-determined deemed profit rate and any of the gross income, costs or expenditures of the non-resident enterprises that can be accurately accounted. According to the Deemed-profit Measures, the deemed profit rate for consulting services is between 15% to

30%, the deemed profit rate for management services is between 30% to 50% and the deemed profit rate for other services should be no less than 15%.

Announcement 19 further stipulates that, in addition to assessing the enterprise income tax treatment for the secondment arrangement, the in-charge tax authorities should also promote the exchange of information with tax authorities responsible for the collection of individual income taxes and business taxes that may be triggered by the secondment arrangement.

4. Foreign Exchange Remittance

Moreover, tax authorities are required under Announcement 19 to timely handle the foreign exchange payment formalities for the Dispatching Entity or the Recipient Entity pursuant to the relevant regulations when determining the tax treatment of secondment arrangements. This requirement mainly refers to the issuance of a tax certificate. In accordance with the relevant regulations, when making remittance of certain service trade items, such as the payment of service incomes to foreign entities or remunerations for personal services, a tax certificate issued by the tax authorities should be obtained if a single payment amounts to more than USD 30,000 (or the equivalent in other foreign currencies). As such, the tax authorities should promptly arrange to issue the tax certificate after ascertaining whether taxes should be imposed on the Dispatching Entity as a result of the secondment arrangement.

Our Observations and Recommendations

As compared to Circular 75, Announcement 19 sets out more detailed provisions in respect of the determination of the existence of a place/establishment of business or permanent establishment under secondment arrangements. However, there are still some open issues. For example, when the seconded personnel holds senior management positions, they usually have to report their work to the corporate headquarters (i.e., the Dispatching Entity), and the corporate headquarters would bear the responsibilities and risks of their work to certain extent. In this case, it remains unclear as to whether the Dispatching Entity would be regarded as having a place/establishment of business or permanent establishment in China even if the Recipient Entity reimburses the Dispatching Entity at cost, and the individual income tax is paid in full for the entire amount of salaries and wages of the secondment personnel.

In addition, pursuant to Announcement 19, if a Dispatching Entity is deemed to have a place/establishment of business or permanent establishment in China, the Dispatching Entity is obliged to perform tax registration and fulfill tax filing and payment obligations on its own. However, there may be certain practical difficulties for a non-resident Dispatching Entity to pay taxes directly in China. The source of RMB funds to settle tax payments would be one of the difficulties faced by the Dispatching Entity. In practice, assistance of the Recipient Entity with regard to the tax payment may be necessary.

Although Announcement 19 does not explicitly refer to the application for tax treaty benefits by the Dispatching Entity, the policy interpretation (the "**Interpretation**") released simultaneously by the SAT with Announcement 19 confirms that the Dispatching Entity may enjoy tax treaty benefits. The Dispatching Entity should make a filing to the in-charge tax authority in accordance with the relevant regulations. If the materials submitted evidences that the Dispatching Entity does not have a permanent establishment in China, the Dispatching Entity would not be subject to enterprise income tax in China.

Furthermore, Announcement 19 requires the tax authorities to promote the foreign exchange remittance procedures after ascertaining tax liabilities of the Dispatching Entity. The reiterates that if the application form and other materials for foreign exchange remittance purposes submitted by domestic institutions are complete and appropriate, the tax authorities shall issue the tax certificates on the spot. Tax authorities shall not delay or hinder the normal foreign exchange remittance of enterprises on the ground of difficulties in determining the tax liability. We hope that this provision can be effectively implemented in practice, as it may reduce the time required for foreign exchange remittance.

Enterprises that implement secondment arrangements should review the relevant contracts or agreements, personnel management regulations and the individual income tax treatment of seconded personnel in light of Announcement 19. In order to avoid the judgement of constituting a place/establishment of business or permanent establishment in China, enterprises should be ensure that:

- The seconded personnel enter into employment contract with the Recipient Entity;
- The employment contract, personnel management regulations and other relevant documents (such as a joint venture contract) specify that the Recipient Entity is responsible for determining the qualifications, quantity and place of work for the seconded personnel, assuming responsibilities and risks of the seconded personnel's work, and be responsible for the performance appraisal of the seconded personnel;
- The Recipient Entity reimburse the Dispatching Entity at cost for the salaries and wages, social insurance premiums and other employment related payment made to the seconded personnel;
- The salaries and wages of the seconded personnel are taxed to the individual income tax in full (i.e., for the seconded expatriate employees, their individual income tax should not be reduced based on the days of their actual presence in China).

Important Announcement

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