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SAT clarifies when a secondment arrangement creates a PE

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Introduction

China's State Administration of Taxation (SAT) issued guidance on 19 April 2013 (Bulletin 19), that clarifies when the secondment of an employee by a nonresident company will give rise to a taxable presence (i.e. establishment) – or permanent establishment (PE) – in China. This was followed by a SAT interpretation note issued on 6 May. Bulletin 19 clarifies and expands on SAT guidance on secondments released in 2010 (Guo Shui Fa [2010] No. 75 (Circular 75)). The new rules articulated in Bulletin 19 apply as from 1 June 2013.

Bulletin 19 provides welcome clarification of the PE risk associated with certain secondment arrangements and, in this regard, it introduces a two-prong test for determining whether a seconded employee remains the employee of the nonresident company (with the result that the activities of the expatriate employee create a PE in China) or whether the individual is an employee of the host Chinese company. The guidance also directs the Chinese tax authorities to undertake a robust review of documentation and the substance of secondment arrangements, and sets out the type of documentation/information that companies should maintain to minimize challenges.

A. "Two-prong" test

Although not specifically stipulated in the bulletin (but described in the separately issued Interpretation Note), the SAT takes the position that an establishment will arise under Chinese domestic law if the nonresident company satisfies a two-prong test, consisting of a "basic factor" and one of five "reference factors:"

Basic factor: The nonresident company bears all or part of the responsibilities and risks for the work product of the seconded employee and routinely conducts the individual's performance evaluations.

Five reference factors:

1) The Chinese company pays management or service fees or fees of a similar nature to the nonresident company;
2) The payments made by the Chinese company to the nonresident company are greater than the amount of the remuneration, social welfare and other costs of the seconded employee paid by the nonresident company;
3) The payments made by the Chinese company are partially retained by the nonresident company;
4) The remuneration borne by the nonresident company was not fully taxed in China; and

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5) The nonresident company decides on the number, qualification, remuneration and working place of seconded employees.

The Bulletin further provides that, for purposes of the application of a tax treaty, a PE would exist if the establishment through which the business of the nonresident is carried on is relatively “fixed” and "permanent."

B. Documentation and substantive review

To determine whether the nonresident company has any enterprise income tax liability, Bulletin 19 stipulates that the tax authorities should review specific documents, as well as the actual substance of the secondment arrangement. The following documentation and information will be relevant:

- Any agreements between the nonresident company, the Chinese company and the seconded employee;
- Any internal management guidelines prepared by the nonresident company or the Chinese company in respect of seconded employees, e.g. with respect to job responsibility, risk, evaluation, etc.;
- Information on payments made by the Chinese company to the nonresident company, the relevant accounting treatment and the settlement of the seconded employee’s individual income tax (IIT) liability; and
- Information on any disguised payments (e.g. offsetting, the waiver of debt, related party transactions, etc.) relating to the secondment.

C. Stewardship services

Bulletin 19 provides that if the seconded employee furnishes services in China solely for the purpose of exercising the rights of a nonresident company (that is the shareholder of the Chinese company), these activities should not give rise to an establishment or PE of the nonresident company in China. Examples of such activities include the provision of investment advisory services to the nonresident company in respect of the Chinese company and representing the nonresident company at shareholder and/or board of directors meetings.

Preliminary Observations

A critical factor in ascertaining whether a PE in China has been created as a result of the activities of an expatriate employee is the actual identity of the “employer” of the individual concerned. To that end, Bulletin 19 continues to adopt the substance over form approach in making such a determination and provides for a "two-prong" test. The basic determining factors and approach of this test are an extension of the principles in Circular 75 and are largely consistent with the relevant principles in the 2010 OECD Model Treaty. The basic factor focuses on the relationship between the nonresident company and the individual: whether in substance they still maintain an employer-employee relationship. The five reference factors largely focus on financial arrangements between the nonresident company and its Chinese affiliate to assess whether the nonresident company derives income as a result the arrangement.

Bulletin 19 is helpful in clarifying the PE risk associated with typical secondment arrangements. The SAT seems to discourage certain reimbursement schemes. Currently, many nonresident companies pay remuneration and other related costs to a seconded employee in advance, then seek full reimbursement from the Chinese affiliate through a service fee arrangement (or other transactions), with or without a mark-up. Such structures are often set up to take account of various business and regulatory considerations (e.g. SAFE constraints, etc.). However, unless the characterization of the relationship between the nonresident company and the seconded employee is beyond doubt (unless it is totally clear that "*basic factor*" test is not satisfied), the first of the five reference factors seems to suggest that such a reimbursement scheme would be detrimental when determining whether a PE has been created by the activities of a seconded employee.

Further, the first three reference factors seem to imply that a PE in China could be created where a group company deploys employees worldwide through an internal HR company, which typically charges a small fee.

On the other hand, the second and third reference factors reconfirm the SAT's view in Circular 75 that, from a Chinese enterprise income tax perspective, a direct reimbursement by a Chinese company is acceptable if the nonresident company does not earn a profit from the arrangement. The arrangement itself should not be viewed as a negative factor in determining whether a PE is created as a result of a secondment arrangement.

Lastly, as stated above, Bulletin 19 mandates that the tax authorities undertake a vigorous review to assess the tax obligations of a nonresident company. To minimize the possibility of challenges, all documentation relating to secondment arrangements should be drafted with care and should include the intercompany agreement, the secondment policy and guidelines, the employee secondment letter and details of any reimbursement requirements. Affected companies also should ensure the terms of the documentation are adhered to and that the substance of the arrangement (e.g. activities carried out by both the companies and the individual) supports what is prescribed in the documentation.

Short and medium-term secondment

Further to Circular 75, Bulletin 19 explicitly links the Chinese IIT treatment of an individual seconded by a nonresident company with a potential PE assessment of the nonresident company.

Bulletin 19 specifically requires that the "remuneration borne by the nonresident company and not fully taxed in China" be considered as one of the criteria in determining whether a PE exists. This implies that under a secondment arrangement that does not constitute a PE, individuals assigned by a nonresident company to its Chinese affiliate normally should be the economic employees of the local affiliate, and the affiliate should properly report their Chinese IIT. If the nonresident company continues to bear the remuneration costs for such individuals and the remuneration is not fully taxed in China, the nonresident company may be considered the economic employer of the individuals during their secondment in China, which could result in a PE. In practice, this position could impact nonresident companies that send foreign individuals to work in China for a short or medium-term period and continue to bear the costs of the remuneration of the individuals and try to limit travel to China to avoid reporting their Chinese IIT. These types of mobility arrangements are clearly at risk under Bulletin 19 and should be reviewed carefully.

Dual-employment

Companies also should examine any dual employment arrangements, under which a seconded employee works for both the nonresident company and the Chinese affiliate and receives remuneration from both companies. In practice, it is often difficult to demonstrate to the satisfaction of the Chinese tax authorities that there is a clear separation of work (under a dual employment arrangement) performed by the individual for the Chinese company and the nonresident company and the corresponding risk and responsibility borne by both companies. Therefore, in these cases, a thorough review of the assignment/employment structure and relevant documentation is recommended to avoid a potential PE challenge.

Conclusion and Recommendations

While Bulletin 19 provides welcome guidance on the PE risk associated with certain secondment arrangements, the bulletin heralds a stepping up of the SAT’s administration of cross-border secondment arrangements. A nonresident entity that assigns employees to China to perform services for a Chinese subsidiary or an affiliate for extended periods without having the subsidiary/affiliate employ the individuals locally run the risk of being regarded as having a PE in China as a result of the individuals’ activities. This is an area where taxpayers can expect intense scrutiny from the Chinese tax authorities. Companies that regularly assign or second expatriate employees to Chinese subsidiaries/affiliates should review their secondment practices and policies to ensure that both the form and substance of the arrangements are aligned with the guidelines in Bulletin 19, Circular 75 and the Commentary to the OECD model treaty.

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